ISSUE DATE: June 10, 1996

DOCKET NO. G-008/GR-95-700

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

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OF LAW, AND ORDER

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BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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In the Matter of the Application of Minnegasco, a Division of NorAm Energy Corp., for Authority to Increase Its Natural Gas Rates in Minnesota

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FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

PROCEDURAL HISTORY

I. INITIAL PROCEEDINGS

On August 11, 1995, Minnegasco filed a general rate case petition. In its filing, Minnegasco requested a rate increase of $24,349,000, or approximately 4.2 percent over existing rates. Minnegasco proposed a projected test year ending September 30, 1996.

On October 4, 1995, the Commission issued Orders accepting the filing, suspending rates, requiring certain further filings, and setting the matter for contested case hearings. The Office of Administrative Hearings assigned Administrative Law Judge (ALJ) Allen Giles to the case.

In the October 4, 1995 Order setting the matter for hearing, the Commission directed the parties to address the following issues in the course of the contested case proceedings: 1) Is the test year revenue increase sought by the Company reasonable or will it result in unreasonable and excessive earnings by the Company? 2) Is the rate design proposed by the Company reasonable? 3) Are the Company's proposed capital structure and return on equity reasonable?

The Commission also directed the Company not to include the following matters in any proposed settlement: 1) the Company's incentive compensation program; 2) Minnegasco's use of an imputed, hypothetical capital structure rather than an independent, actual capital structure; 3) the Midwest Gas acquisition adjustment; 4) the Company's low income discount program; 5) manufactured gas plant cleanup costs; 6) plant-related expenses to serve new customers (including the ongoing requirements of maintaining and upgrading Minnegasco's distribution system); 7) increased computer costs; and 8) the use of NorAm's consolidated tax calculations in the rate case.

On October 10, 1995, the Commission issued an Order setting interim rates, authorizing an interim rate increase of $17,772,000, or approximately 3.12 percent, for service rendered on and after October 10, 1995.

The ALJ held a preheating conference on October 18, 1995, and issued a Preheating Order on November 22, 1995.

II. PARTIES AND REPRESENTATIVES

A. Participating Intervenors

The participating intervenors and their representatives in this matter are as follows:

The Department of Public Service (the Department), Dennis Ahlers, Kathy McGill, and Brent Vanderlinden, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, MN 55101-2130.

The Residential Utilities Division of the Office of Attorney General (RUD-OAG), Eric Swanson and Anu Seam, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, MN 55101-2130.

Suburban Rate Authority (SRA), James M. Strommen, Holmes & Graven, 470 Pillsbury Center, 200 South Sixth Street, Minneapolis, MN 55402.

Energy CENTS Coalition (ECC), Pam Marshall, 1916 Second Avenue South, Minneapolis, MN 55404.

Minnesota Propane Gas Association (MPGA), Laurance R. Waldoch, Lindquist & Vennum, 4200 IDS Center, 80 South Eighth Street, Minneapolis, MN 55402-2205.

In addition, Minnesota Energy Consumers (MEC) submitted briefs but did not appear.

B. The Company

Minnegasco was represented by Paul T. Ruxin, Jones, Day, Reavis & Pogue, North Point, 901 Lakeside Avenue, Cleveland, OH 44114, and Brenda A. Bjorklund and Douglas W. Peterson, Minnegasco, 800 LaSalle Avenue, P.O. Box 59038, Minneapolis, MN 55459-0038.

III. PUBLIC HEARINGS AND PUBLIC TESTIMONY

The ALJ held public hearings to receive comments and questions from non-intervening ratepayers. Public hearings were held in Bloomington on December 5, 1995; in Minneapolis and Coon Rapids on December 6, 1995; in Mankato on December 13, 1995; and in Brainerd on December 14, 1995.

Approximately 114 members of the public attended the public hearings. The ALJ estimated that members of the Minnesota Utility Investors comprised 95% of the public in attendance. Most people who commented expressed concern about the proposed residential rate increase.

In addition, approximately 61 ratepayers submitted letters and a number of ratepayers contacted the Commission's Consumer Affairs division regarding the pending rate case. Most parties who submitted written or verbal comments opposed increases in the basic charge or gas rate.

IV. EVIDENTIARY HEARINGS

Evidentiary hearings were held on January 22-23, 25-26, and 29-31, 1996.

V. SUBMISSION OF THE SETTLEMENT AND STIPULATION

On January 25, 1996, Minnegasco and the Department entered into an Offer of Partial Settlement, which included settled issues, stipulated facts, and a recommended decision on certain revenue requirement issues. No other party to the proceeding signed the Settlement.

The parties to the Settlement followed Commission instructions in avoiding settlement of the eight issues listed in the Commission's October 4, 1995 notice and order for hearing. On three of these issues, however, the parties stipulated as to the facts and recommended a decision. The three issues were line extensions, environmental expenses, and the low income discount rate. The parties agreed that a Commission modification to the recommended decisions on these issues would not require further evidentiary hearings.

Minnegasco and the Department stated that the agreement on the settled issues is expressly conditioned upon the Commission's acceptance of the Settlement in its entirety, without modification, except as revenue requirement or rate design effects may be changed as a result of the Commission's resolution of the stipulated or disputed issues. The parties agreed that if either party rejected a Commission modification of the Settlement, the Settlement would be null and void and hearings would recommence upon all settlement matters.

On January 31, 1996, the parties submitted an addendum to the Offer of Partial Settlement, entitled Exhibit 125. The addendum reflected the parties' agreement regarding economic development expenses.

The Settlement as filed, including Exhibit 125, would reduce Minnegasco's original filed operating expenses by $3,695,419 and rate base by $3,073,662.

The ALJ found that there was sufficient evidentiary support for the Settlement in the pre-filed testimony, schedules, hearing transcripts, and additional material attached to and made a part of the Settlement.

VI. PROCEEDINGS BEFORE THE COMMISSION

On April 12, 1996, the ALJ filed his final report and recommendation.

On May 8, 1996, the Commission heard oral arguments from the parties and on May 10, 1996, the Commission met to deliberate this matter.

Upon review of the entire record of this proceeding, the Commission makes the following Findings of Fact, Conclusions of Law, and Order.

FINDINGS AND CONCLUSIONS

VII. JURISDICTION

The Commission has general jurisdiction over the Company under Minn. Stat. §§ 216B.01 and 216B.02 (1994). The Commission has specific jurisdiction over rate changes under Minn. Stat. § 216B.16 (1994).

The case was properly referred to the Office of Administrative Hearings under Minn. Stat. §§ 14.48-14.62 (1994) and Minn. Rules, part 1400.0200 et seq. (1995).

VIII. FURTHER ADMINISTRATIVE REVIEW

Under Minn. Rules, part 7829.3000 (1995), any petition for rehearing, reconsideration, or other post-decision relief must be filed within 20 days of the date of the Order. Such petitions must be filed with the Executive Secretary of the Commission, must specifically set forth the grounds relied upon and errors claimed, and must be served on all the parties. The filing should include an original, 15 copies, and proof of service on all parties.

Adverse parties have ten days from the date of service of the petition to file answers. Answers must be filed with the Executive Secretary of the Commission and must include an original, 15 copies, and proof of service on all parties. Replies are not permitted.

The Commission, in its discretion, may grant oral argument on the petition or decide the petition without oral argument.

Under Minn. Stat. § 216B.27, subd. 3 (1994), no Order of the Commission shall become effective while a petition for rehearing is pending or until either of the following: ten days after the petition for rehearing is denied or ten days after the Commission has announced its final determination on rehearing, unless the Commission otherwise orders.

Minn. Stat. § 216B.27, subd. 4 (Supp. 1995) provides that any petition for rehearing not granted within 60 days of filing is deemed denied.

IX. THE COMPANY

Minnegasco is a natural gas distribution company headquartered in Minneapolis, Minnesota. The Company is engaged in the sale and distribution of natural gas to approximately 620,000 customers in 200 Minnesota communities. The largest metropolitan areas served by Minnegasco are Minneapolis and its western metro suburbs. Minnegasco previously served portions of Nebraska and South Dakota, but in early 1993, the Nebraska operations were sold to Utilicorp. In mid-1993, Minnegasco exchanged the South Dakota properties for Midwest Gas Company's Minnesota operations.

Minnegasco purchases the vast majority of its gas directly from producers. It serves its Minnesota customers with natural gas transported by the Northern Natural Gas and Viking Pipeline systems. The Company's gas distribution system consists of over 9,800 miles of mains. Minnegasco provides natural gas service according to a schedule of rates for the following customer rate classes: Residential, Commercial/Industrial, Large General Service, Small Volume Dual Fuel, and Large Volume Dual Fuel.

On November 29, 1990, Minnegasco became an operating division of Arkla, Inc., now known as NorAm Energy Corp. (NorAm).

X. BURDEN OF PROOF

Minn. Stat. § 216B.16, subd. 4 (1994) states: "The burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change." Under Minn. Stat. § 216B.03 (1994), every rate made, demanded or received by any public utility "...shall be just and reasonable...Any doubt as to the reasonableness should be resolved in favor of the consumer."

The Minnesota Supreme Court has articulated standards for the burden of proof in rate cases. In the Matter of the Petition of Northern States Power Company for Authority to Change Its Schedule of Rates for Electric Service in Minnesota, 416 N.W. 2d 719 (Minn. 1987). In the Northern States Power case the Court divided the ratemaking function of the Commission into quasi-judicial and legislative aspects. The Commission acts in a quasi-judicial mode when it determines the validity of facts presented. Just as in a civil case, the burden of proof is on the utility to prove the facts by a fair preponderance of the evidence. Such items as claimed costs or other financial data are facts which the utility must prove by a fair preponderance of the evidence.

The Commission acts in a legislative mode when it weighs the facts presented and determines if proposed rates are just and reasonable. Acting legislatively, the Commission draws inferences and conclusions from proven facts to determine if the conclusion sought by the utility is justified. The Commission weighs the facts in light of its statutory responsibility to enforce the state's public policy that retail consumers of utility services shall be furnished such service at reasonable rates. In its legislative capacity, the Commission forms determinations such as the usefulness of a claimed item, the prudence of company decisions, and the overall reasonableness of proposed rates.

The utility therefore faces a two part burden of proof in a rate case. When presenting its case in the rate case proceeding, the utility has the burden to prove its facts by a fair preponderance of the evidence. The utility also has the burden to prove, by means of a process in which the Commission uses its judgment to draw inferences and conclusions from proven facts, that the proposed rates are just and reasonable.

XI. THE TEST YEAR

Minnegasco proposed October 1, 1995-September 30, 1996 as the test year period to be used as the basis for determining its revenue requirements for providing natural gas service. The Company used 1994 as its base year, then made adjustments to 1994 base year financial data to properly reflect test year expenses.

No party objected to Minnegasco's development of its test year.

The ALJ stated that test year data should be representative of normal utility operations that are expected to exist when the proposed rates will be in effect. The ALJ found that Minnegasco's proposed test year was reasonable.

The Commission agrees with and adopts the ALJ's finding on the proposed test year.

XII. THE OFFER OF PARTIAL SETTLEMENT

In the Commission's October 4, 1995 Order setting this matter for hearing, the Commission asked the parties not to settle the following issues that the Commission believed warranted full evidentiary development: 1) incentive compensation; 2) Minnegasco's use of an imputed, hypothetical capital structure rather than an independent, actual capital structure; 3) the Midwest Gas acquisition adjustment; 4) the Company's low income discount program; 5) manufactured gas plant cleanup costs; 6) plant-related expenses to serve new customers; 7) increased computer costs; and 8) the use of NorAm's consolidated tax calculations in the rate case.

During settlement discussions between Minnegasco and the Department, the parties reached agreement on three of the above issues--line extensions, environmental expense, and the low income discount program. In deference to the Commission's directive, the parties did not settle these issues but rather placed them in a separate Stipulation of Facts and Issues in the overall Offer of Partial Settlement. The parties offered an agreed-upon recommended decision for each of the three issues.[1]

The Offer of Partial Settlement, including Exhibit 125, also contained a Settlement Section containing nine revenue requirements issues settled between Minnegasco and the Department.

Finally, the Offer of Partial Settlement contained a list of four issues that were not specifically settled but were not disputed by Minnegasco, the Department, or any other party to the rate case. The four issues listed were: 1) costs of the cost allocation case, Docket No. G-008/CI-91-942; 2) the good will adjustment; 3) liquefied natural gas sales to Burlington Northern; and 4) FAS 106 funding. These issues were included in a section entitled Issues Not in Dispute.

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[1] Two of the three stipulated issues, line extensions and low income discount rates, were contested by other parties who were not signatories to the Offer of Partial Settlement. These issues will be discussed in Section XIV of this Order.

The Stipulation Section and Settlement Section of the Offer of Partial Settlement have different purposes and functions and must be treated differently. The Stipulation documents agreement by the parties on discrete factual and policy issues which have been resolved independently of one another. It is not presented as the product of compromise. Its resolution of any individual issue does not depend upon its resolution of any other issue or upon acceptance of the stipulation as a package.

The effect of the Stipulation Section of the Offer is the same as the effect of the parties individually taking the same position on the stipulated issues. The parties have simply formalized their agreement on the stipulated issues and offered their consensus as evidence of the reasonableness of their positions. For these reasons, the Commission may accept parts of the Stipulation without accepting others, and without giving the parties a chance to change their positions on the stipulated issues.

The Settlement Section, on the other hand, is offered as the product of compromise. Settlements are encouraged under Minn. Stat. § 216B.16, subd. 1(a), which requires the Commission to consider and deal with them as a package. The statute recognizes that a settlement is an integrated whole whose individual provisions are mutually dependent and may be linked in ways that are not immediately apparent. The statute, therefore, gives any settling party the right to reject any modification the Commission makes to a settlement and to return to hearing.

The Offer of Partial Settlement as filed, taken as a whole, would reduce Minnegasco’s original filed operating expenses by $3,695,419 and rate base by $3,073,662.

The ALJ examined the Settlement Section, and each issue settled, for reasonableness and support in the record. The ALJ found that there was sufficient evidentiary support for the Settlement in the pre-filed testimony, schedules, hearing transcripts, and additional material attached to and made a part of the Settlement.

The ALJ also examined each issue in the Stipulation Section and found the Stipulation’s resolution of each issue reasonable and supported by substantial evidence in the record. He recommended acceptance of the Stipulation Section of the Offer of Partial Settlement.

Finally, the ALJ noted the four issues in the Issues Not in Dispute section. The ALJ recommended acceptance of the Offer of Partial Settlement in its entirety.

The Commission will consider the three parts of the Offer of Partial Settlement separately.

XIII. SETTLEMENT ACCEPTED

The Settlement Section of the Offer of Partial Settlement, which is attached, resolves the following issues:

Advertising Issues
Marketing and Customer Service Expense
Inflation

Rate Case Expense
Gas Leaks and Winter Residential Leak Surveys
Sales Forecast
Revenue from Curtailment Penalties
Telemetry Equipment
Economic Development Expenses

The parties thoroughly supported the resolution of each issue in the Settlement with specific reference to the record. The parties thus demonstrated that the facts in the record were central to their negotiations on every issue. Minnegasco and the Department also made their witnesses available for questioning by the ALJ and Commission Staff, to support and clarify, if necessary, the evidentiary basis.

After carefully considering the record on the issues included in the Settlement Section, the Commission finds that the parties have supported their positions and grounded their resolutions in the facts. The Commission finds that the Settlement Section is supported by substantial evidence, represents a just and reasonable resolution of the individual issues settled, promotes the public interest, and will result in just and reasonable rates. The Commission accepts and adopts the Settlement Section of the Offer of Partial Settlement.

XIV. STIPULATED ISSUES RESOLVED

Minnegasco and the Department included the following issues in the Stipulation Section of the Offer of Partial Settlement: MGP cleanup environmental expense; the low income discount rate; and line extensions. The issues were matters upon which the parties found a common position but which were barred from settlement by Commission Order.

The parties tied each stipulated issue and recommended decision to the supporting record. Minnegasco and the Department also made their witnesses available for questioning by the ALJ and the Commission Staff.

The ALJ found that each of the stipulated issues and recommended decisions was reasonable and should be adopted.

The Commission will consider the three stipulated issues and recommended decisions in turn.

A. MGP Cleanup Environmental Expense

1. The Stipulated Facts and Recommended Decision

Minnegasco estimated that it would spend approximately $8,790,000 in the test year on investigation and remediation of two former manufactured gas plant (MGP) sites, the Minneapolis Gas Works plant and the Willmar site. The Company also projected $111,000 in related legal costs and $539,000 in insurance recovery litigation for a total test year expense of $9,440,000.

Minnegasco estimated that $4.5 million per year represents a more normal, ongoing annual rate case expense for MGP cleanup costs. The Company therefore proposed $4.5 million as the test year MGP environmental expense. The $4.94 million difference between the test year estimate of $4.5 million and the full projected cost of $9.44 million would be amortized over two years at $2.47 million per year. Minnegasco proposed including in rates the test year normal amount of $4.5 million, plus the $2.47 million amortization, for a total of $6,970,000.

The Department stated that the proposed test year sum of $9.44 million is appropriately supported in the record. The Company supported the $4.5 million ongoing expense with estimates for two years beyond the test year. Based upon these facts, the Department agreed to a stipulated amount of $6,970,000 for test year MGP environmental cleanup expenses.

No party contested the stipulated facts and recommended decision.

2. Commission Action

The Commission agrees with the ALJ that the parties have sufficiently supported their facts and that the stipulation regarding MGP environmental test year expenses should be accepted.

Further issues related to environmental cleanup were contested by the parties and will be discussed at Section XVI of this Order.

B. Low Income Discount Rate

1. The Stipulated Facts and Recommended Decision

On December 2, 1994, the Commission issued its ORDER APPROVING REVISED ENERGY EVALUATION PROPOSAL AND ALLOWING DEFERRAL OF COSTS[2], in which the Commission approved a low income discount pilot program for Minnegasco, pursuant to the requirements of Minn. Stat. § 216B.16, subd. 15. Among other things, the Order allowed Minnegasco to defer the costs of providing the low income discount, until the deferred costs could

[2] In the Matter of a Low-Income Residential Pilot Program for Minnegasco, Docket No. G-008/CI-94-675.

be examined in a future rate case. The Company began deferring the costs of offering its program discount on February 1, 1995.

In the current rate case, Minnegasco proposed recovery of the $430,000 deferred balance as of September 30, 1995, amortized over two years. The Company would add the annual $215,000 amortization to test year program discounted rates of $550,000, resulting in $765,000 in test year costs for the low income pilot. The Company also included $323,000 in the test year rate base.

Minnegasco also proposed establishing a tracker account to track recoveries in rates and actual costs incurred. The tracker amount would be credited by Minnegasco with any savings identified in future reports to the Commission, in which the Company would identify the net costs of the program. Differences, with carrying charges, would be reconciled in future rate proceedings. Minnegasco proposed recovering the net costs of the program from residential sales service customers on a per customer basis.

The Department recommended several changes to the Company's original proposal. To estimate savings associated with the low income rate, such as lower collection costs or less bad debt expense, the Department calculated an adjustment which would reduce test year expense by $78,000 and rate base by $31,500. The Department also recommended that the tracker apply from the beginning of the pilot to when Minnegasco changes the rates at the end of the program; that the September, 1995 tracker balance be adjusted for estimated positive saving and actual discounts; that the expected discounts during the test year be adjusted for expected attrition; and that all firm customers be required to pay for the low income discount.

The RUD-OAG recommended an alternative adjustment to reflect future savings associated with offering the low income discount. Under the RUD-OAG's calculation, if Minnegasco were unable to offer direct evidence of savings it would be allowed to recover only 75% of its gross costs of the program. According to the RUD-OAG, allowing a greater recovery would remove the necessary incentive for the Company to identify savings and return them to ratepayers. In the future, if savings can be accurately demonstrated to be less than 25% of program costs, Minnegasco would be allowed a recovery greater than 75%.

The Company agreed to all of the Department's recommended adjustments. Minnegasco and the Department stipulated to the Company's proposal, with the Department's proposed changes.

2. Commission Action

The Commission agrees with the ALJ that the parties' stipulated facts and recommended decision should be adopted. Minnegasco and the Department have presented clear evidence that the Company's proposal, as modified by the Department, will result in the Company's reasonable recovery of its statutorily-mandated program costs. The Department's suggested savings calculation should accomplish the RUD-OAG's goal of matching test year program costs with associated savings.

C. Line Extensions

1. Factual Background

Since filing its last rate case, Minnegasco has made major service expansions in 23 areas: Mille Lacs, Buckman, Ravenna Township, Luxemburg, Miesville, New Trier, Avon, Big Lake/Orrock, Cold Spring, Corinna Township, Dovre Township, East Side, Frankfort, Laketown, Corcoran, Mankato, Maple Lake, Medford, Medina, Monticello, New Prague/Cedar Lake, Otsego, and Savage.

Most of these expansions represented a sharp break with past practice. Until 1993, it had been Company policy to expand only when potential customers in areas bordering the Company's existing service area requested service. In early 1993 this changed. Anticipating increasing competition in the natural gas industry, Minnegasco decided to identify and move into areas with high growth potential, whether or not they had a current need for natural gas service. As one Company witness explained:

> We wanted to be in those areas. Whether there was a customer there today was irrelevant. We believed these areas, based on the documentation that we have seen, have significant growth potential. We want to be in those areas.
>
> Transcript VI, p. 731.

Since these expansions were based on projected future growth, the Company could not consistently apply its normal main and line extension tariffs. Per-customer assessments under these tariffs, which require customer contributions for main extensions over 150 feet and line extensions over 105 feet[3], would have been exorbitant. Instead, the Company exercised its general discretion to waive excess footage fees[4] and placed the costs in rate base, to be passed on to the general body of ratepayers.

Total amounts waived do not appear in the record, but clearly exceed $1,981,713, the total of main waivers for all 23 areas plus service line waivers for six of the 23. MPGA Exhibit 117, Sch. 3, p. 1 and p. 12.

2. Positions of the Parties

a. Minnesota Propane Gas Association

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[3]The 105 foot allowance applies when measuring from the center of a publicly dedicated street or alley or public or private utility easement. When measuring from the property line, the allowance is 75 feet. Calculations are based on whichever distance is greater.

[4]Company tariffs grant it discretion as summarized by the Company witness as follows: "Gas main can be installed without charge where Minnegasco deems the anticipated revenue is sufficient or where Minnegasco determines the conditions justify such installation." Transcript VI, p. 693.

The Minnesota Propane Gas Association (the MPGA) is an organization of propane and natural gas dealers. Its members are in direct competition with Minnegasco in the 23 expansion areas discussed above.

The Association intervened to focus Commission attention on what it sees as a growing trend for major natural gas utilities to expand into sparsely populated areas which could not support natural gas service without major subsidies from other ratepayers. The MPGA claimed that in this case the economic interests of its members and the public interest in fair competition, efficient resource allocation, and sound ratemaking coincide.

The MPGA asked the Commission to remove from rate base the $1,981,713 in footage charges the Company conceded waiving in the 23 areas at issue and to order the Company to file the information necessary to determine the total amount of footage charges waived.

The MPGA also asked the Commission to modify the New Area Surcharge it has recently established to deal with expansions, to order Minnegasco to use the modified New Area Surcharge for all future expansions, to modify the Company's extension tariffs to remove its discretion to waive excess footage charges, and to explicitly hold that any subsidies associated with future expansions should be paid by shareholders, not ratepayers.

b. The Company and the Department

The Company and the Department agreed that rate base should be reduced by $1,578,134 to reflect system expansions that were not economically justified or violated the Company's excess footage tariffs. The $1,578,134 figure has two components -- (1) the net present value of the difference between the cost of service and the expected revenue for four of the 23 expansion projects ($949,561); and (2) the total of excess main footage charges waived for the rest of the 23 expansions ($628,573).

The Company maintained on brief and in oral argument, however, that it had been fully justified in placing all expansion costs in rate base and had stipulated to a rate base reduction in agreement with the Department, not with the MPGA.

3. The ALJ

The Administrative Law Judge accepted and adopted the stipulated rate base reduction as reasonable and supported in the record.

4. Commission Action

a. Summary of Commission Action

The Commission finds that the stipulated rate base reduction is not supported by substantial evidence, that the appropriate reduction is the full amount of excess footage charges waived, and that the most accurate estimate of those charges available from the record is $3,268,994. Associated depreciation, also disallowed, totals $146,000.

The $3,268,994 figure consists of the actual amount of main excess footage charges waived for all 23 areas, the actual amount of service line excess footage charges waived for six of the 23 areas, and an extrapolation of the excess service line footage charges waived for the other 17 areas.[5]

The Commission finds that the Company was not justified in waiving excess main and excess line extension footage charges and placing associated costs in rate base.

b. The Stipulated Rate Base Reduction

Originally, the Department based its claim for a rate base reduction on an economic analysis of a sample of the 23 expansion projects. The analysis focused on whether the sample projects would eventually recover their costs, using an economic model similar to the one used by the Commission to establish the New Area Surcharge tariff. (That tariff governs current expansions into new areas, and requires surcharging customers for expansions that would not otherwise recover costs.) The sample projects were not projected to recover their costs, and the Department recommended a rate base reduction on prudence grounds.

As the case developed, the Department came to focus more heavily on its belief that the Company had failed to comply with its tariffs requiring customers to pay for main and service line extensions exceeding specific lengths. Ultimately, the Department and the Company stipulated to a rate base reduction that combined the two methods, as set forth above.

The Commission rejects the stipulated reduction as having an insufficient basis in fact. The $1,578,134 figure combines two numbers that have very little in common -- the total ratepayer subsidy for four projects as measured by a sophisticated economic analysis and the gross total of gas main excess footage charges waived for the remaining projects -- while at the same time it fails to include another important component, excess service line charges waived. The stipulated number does not appear to represent a serious attempt to capture the actual amount by which rate base has been inflated by the inclusion of subsidies for uneconomic expansions.

While the number might be defensible as part of a settlement, where parties are bargaining with an eye to the bottom line, it makes less sense as part of a stipulation of facts. The reason the Commission directed the parties not to settle this issue was that it considered the issue serious

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[5]The hard numbers were supplied by the Company in response to information requests from the Minnesota Propane Gas Association. MPGA Exhibit 117, Sch. 3, p.1 and p. 12.

enough to warrant the kind of precision that is lacking here.

c. The Commission-Ordered Rate Base Reduction

The Commission agrees with the Company that the most appropriate measure of rate base inflation in connection with its expansion into the 23 new areas is the amount of excess footage charges improperly waived. Deducting waived footage charges would put rate base where it would have been if the Company had complied with its tariffs. Since all the information necessary to calculate that number is not in the record, the Commission made the most accurate estimate it could, as explained above.

d. Imprecision Unavoidable

The Company objected to the MPGA's request to require the Company to file the information necessary to calculate the exact amount of excess main and service line extension charges waived in the 23 expansion areas. The Company emphasized that the MPGA had a duty to secure the information it needed while the record was open and that the Company had no obligation to produce it now.

The Company is correct. Since that information is not in the record, however, the Commission has no alternative to making the most accurate possible estimate of total excess footage charges waived. The Company, after all, has the burden of proving that every dollar in the rate base belongs there. Minn. Stat. § 216B.16, subd. 4. Any doubt is to be resolved in favor of the consumer. Minn. Stat. § 216B.03. The Company has failed to meet its burden of proof as to at least the $3,268,994 portion of the rate base the Commission has disallowed.

e. The Claim to Full Recovery

The stipulation, which the Company signed, stated that line extension issues were not in dispute between the Company and the Department and that rate base should be reduced by $1,578,134. In response to the arguments of the MPGA, however, the Company claimed that no rate base reduction was appropriate, that it was entitled to full recovery of all costs associated with the 23 expansions. The Commission disagrees.

The Company's claim to full recovery rests on two claims: (1) that its tariffs gave it the discretion to waive all excess footage charges in the expansion areas, and (2) that the expansions are part of the system as a whole; as long as all expansions averaged together do not exceed the footage allowances, there is no ratepayer harm.

i. Discretion Granted in Tariffs

The Company's service extension tariffs state that service shall be extended only where economically feasible, to avoid unduly burdening other customers. They require customer contributions for main extensions exceeding 150 feet and service line extensions exceeding 105 feet. Direct Testimony of Dawn Reimer, pp. 30-31.

The tariffs also contain a catch-all provision permitting installation "where [the Company] deems the anticipated revenue is sufficient to warrant such installation or in other cases where Minnegasco determines the conditions justify such installation." Rates and Tariffs Book, Sections VI, First Revised Page 6, Paragraph 4.05. The Company claims this provision justifies waiving customer contributions for excess main and service line footage charges for all 23 expansions. The Commission disagrees.

To read the tariffs as the Company suggests is to eviscerate them. Clearly, the principle governing service extensions is that, once they exceed 150 feet for mains and 105 feet for service lines, costs have reached the point where they can no longer be readily recovered from rates. They must then be separately charged at the per-foot rates specified in the tariff to avoid unduly burdening other ratepayers.

The discretionary provision cited by the Company cannot justify wholesale departure from this or any other tariff requirement. Such provisions are intended to give utilities the flexibility they need to administer their tariffs. Utilities deal with virtually every household, business, and building in the state. Their tariffs cannot speak to every situation they will encounter, and they must be able to exercise judgment to deal with exceptional situations.

In this case, however, tariff requirements were not waived to deal with exceptional situations. They were waived systematically for customers within the 23 expansion areas and applied systematically for customers within the existing service area. Transcript VI, p. 737. The discretion granted in the tariff does not permit systematic waiver of tariff provisions in disregard of underlying tariff principles.

ii. Viewing the System as a Whole

The Company also emphasized that ratemaking always involves averaging the costs of serving similarly situated customers, that all parts of its system are interconnected, that its system operates as a whole. The 23 expansion areas are a small part of the total system, and service extensions within those areas are a small portion of all service extensions completed since the last rate case.

Taking a system-wide view, the Company argued, ratepayers were not harmed, because service extensions under the allowable footage limits far outnumbered those over the allowable footage limits. Lengthy service extensions to the expansion areas were balanced, in the Company's view, by thousands of short service extensions within the metropolitan area.

This overlooks the fact that the ratemaking process, through tariff approval, has already determined that it is fair and reasonable to require customers who need main or service extensions over specified lengths to pay specified charges. The tariff *assumes* that service expansions will average fewer feet than the allowances; rates are based on this assumption and on the assumption that longer extensions will be accompanied by customer contributions. The tariffs are not premised on averaging extensions above and below the footage allowances.

Finally, ratepayer harm is clearly present here, since, had the Company applied the excess footage tariff and collected the customer contributions it required, rate base would have been at least

$3,268,994 lower than the one claimed in the Company's original filing.

f. Tariff Application in Future Expansions

The MPGA also urged the Commission to modify the New Area Surcharge recently developed to deal with Company expansion to new areas, to order the Company to use the New Area Surcharge for all expansions, to modify the Company's extension tariffs to remove its discretion to waive excess footage charges, and to explicitly hold that all subsidies associated with future expansions should be paid by shareholders, not ratepayers.

The Commission is unwilling to revise the New Area Surcharge at this time and in this proceeding. The Surcharge was carefully developed after extensive comments with active participation from interested parties. Until the Commission has practical experience with its application, or clear evidence it is going awry, the Surcharge should remain in place.

The Company assured the parties and the Administrative Law Judge that the New Area Surcharge would prevent future waivers of the sort at issue in this case. On the other hand, the Company's claim that it should be allowed to average service extensions system-wide confuses the issue. The Commission will require a filing demonstrating that the Company understands and has implemented Commission policy requiring individual application of the New Area Surcharge to each new area to which it expands.

The Commission will also require filings describing how the Company will determine when the New Area Surcharge applies, describing the operating and accounting procedures in place to ensure compliance with the New Area Surcharge tariff, and clarifying for tariff purposes that, once the Company waives excess footage charges, it cannot at any point recover the waived charges from ratepayers.

Finally, the Commission will not revise the Company's tariffs to remove its discretion to waive excess footage charges. As explained above, the Commission believes utilities need flexibility to administer their tariffs. Although the footage charge waivers at issue represent serious misapplications of the tariffs, there is no evidence of a pattern or practice of abuse that would require eliminating the flexibility normal in day-to-day tariff administration.

g. Conclusion

The Commission agrees with the MPGA that in this case the economic interests of its members and the public interest in fair competition, efficient resource allocation, and sound ratemaking largely coincide. The Company cannot position itself for what it sees as a new era of increased competition at the expense of current monopoly ratepayers.

The Commission will reduce rate base by the amount of excess footage charges improperly waived, require strict compliance with excess footage tariffs and the New Area Surcharge tariff in the future, and require Company filings demonstrating compliance with these requirements.

XV. ISSUES NOT IN DISPUTE IN THE OFFER OF PARTIAL SETTLEMENT

In the Offer of Partial Settlement, the parties listed the following items which were not in dispute: 1) costs of the Minnegasco cost allocation case, Docket No. G-008/C-91-942[6]; 2) good will adjustment associated with Minnegasco's home security business; 3) liquefied natural gas sales to Burlington Northern; and 4) Financial Accounting Standard (FAS) 106 funding.

A. The Issues Not in Dispute

1. Costs of the Cost Allocation Case

The Company included costs related to Docket No. G-008/C-91-942 as a test year expense, but agreed to the Department's recommendation to exclude $52,000 for outside legal expense.

The ALJ incorporated the adjustment.

2. Good Will Adjustment

The Company agreed to the Department's recommendation to include a proprietary amount for the security systems section of Home Care Services.

The ALJ incorporated the adjustment.

3. Liquefied Natural Gas Sales (LNG)

The Company included costs and revenues related to the sale of LNG to Burlington Northern. Learning that Burlington Northern was discontinuing the program, the Company agreed to remove the amounts from the test year. This reduced the originally-filed test year net income by $74,000.

The ALJ incorporated the adjustment.

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[6] In the Matter of the Complaint of the Minnesota Alliance for Fair Competition against Minnegasco, a Division of Arkla, Inc.

4. Financial Accounting Standard (FAS) 106 Funding

In Minnegasco's most recent rate case, Docket No. G-008/GR-93-1090, the Commission directed the Company to commence external funding through the use of a VEBA trust fund for postemployment benefits related to FAS 106. The Company indicated that it contributed $1.8 million to the NorAm Energy Corp. Employee's Benefits Trust on December 28, 1995. The Department indicated that the Company complied with the prior Order.

The ALJ indicated that there was no dispute that Minnegasco complied with the prior Order.

B. Commission Action

No party submitted any evidence or testimony in opposition to the Company's proposals on these issues. The ALJ accepted the issues as part of the overall Offer of Partial Settlement.

For the reasons discussed in this Order, the Commission has determined that the Offer of Partial Settlement is reasonable and should be adopted. Based on the recommendations of the Department and the ALJ on the above matters, the Commission will accept and incorporate the modifications discussed.

XVI. OTHER NONDISPUTED FINANCIAL ISSUES

A. The Issues

1. The Coon Rapids Office

The Company included the Coon Rapids Office, including the portion sublet to a medical center, in the rate base and income statement in its original filing. Following the evidentiary hearing, the Company discovered that the full cost related to the sublet portion, including return on the rate base portion, was not recovered in the lease revenues included in the test year. The Company then submitted a late exhibit recommending that the costs and revenues related to the sublet portion of the Coon Rapids office be removed from the test year rate base and income statement. The adjustment reducing test year rate base by $692,000 and decreasing test year net income by $13,000 was not disputed by parties to the proceeding.

The ALJ found the adjustment appropriate.

2. General Allocator

The Company calculated a general allocator for purposes of allocating certain general costs to utility or non-utility operations. In response to recommendations by the Department, the Company agreed that franchise fees should not be included in the development of the general allocator because franchise fees are a pass-through item.

In addition, Minnegasco and the Department agreed that it is necessary to recalculate the general allocator to reflect the final determination of the Commission on the many test year expense issues.

The adjustment and recalculation increase test year net income by $56,000.

3. Cash Working Capital/Interest Synchronization

The Company and the Department recognized the need to adjust the cash working capital/interest synchronization calculations to reflect the Commission's final determination on the many rate base and expense issues in this proceeding.

The recalculation increases rate base by $172,000 and income tax expense by $123,000.

B. Commission Action

Based on the recommendations of the Department and ALJ on the above nondisputed matters, and in the absence of opposing comments, the Commission will accept and incorporate the modifications discussed in the matters above.

XVII. REMAINING CONTESTED FINANCIAL ISSUES

A. Environmental Expense--Insurance Payments from 1991 Costs

Minnegasco proposed test year expenses of $6,970,000 for manufactured gas plant (MGP) cleanup costs. Minnegasco also proposed the establishment of an environmental tracker account for MGP costs. No party opposed inclusion of the proposed costs in rates or the establishment of the tracker account.

Two issues related to the costs arose in the rate case proceeding: 1) the amount, if any, of MGP insurance recoveries related to 1991 expenses that should be included in the tracker account; and 2) the application of carrying costs to the tracker account. The Commission will discuss the inclusion of insurance recoveries in this section and the application of carrying costs in Section C below.

1. Factual Background

On August 11, 1992, the Commission issued its ORDER ALLOWING DEFERRED ACCOUNTING TREATMENT AND REQUIRING INFORMATION in Docket No. G-008/M-91-1015.[7] In that Order, the Commission allowed Minnegasco to defer MGP cleanup costs beginning January, 1992, but denied deferral of MGP costs prior to that date. The Commission explained that the Company had not obtained approval of the deferred accounting prior to incurring its 1991 MGP costs; under governing rules and accounting standards, the costs could therefore not be deferred.

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[7] In the Matter of a Request by Minnegasco for Approval of Deferred Accounting for Manufactured Gas Plant Site Investigation, Monitoring, and Remediation Costs.

On September 22, 1995, the Commission issued its ORDER ACCEPTING MANUFACTURED GAS PLANT CLEANUP COST REPORT WITH MODIFICATION in Docket No. G-008/M-95-292[8]. In that Order the Commission addressed Minnegasco's proposal to offset a portion of its current insurance recoveries of 1991 costs by the 1991 MGP cleanup costs. The Commission rejected Minnegasco's proposal, stating that such an offset would in effect rescind the Commission's 1992 decision not to allow deferral of 1991 MGP costs for future rate case consideration.

2. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco adopted certain Department adjustments to the Company's environmental expense proposal. First, while disagreeing in principle, Minnegasco agreed to include the later insurance recoveries related to nondeferred 1991 costs (as determined in the Commission's previous accounting Orders) in the new environmental tracker. Second, Minnegasco agreed that the September 30, 1995 deferred balance should be reduced by an amount which would replace the forecasted expenditures with actual amounts. Third, Minnegasco agreed to include in the tracker insurance recoveries received after the rate case was filed. Minnegasco did not, however, agree to include $272,448 of post-rate filing insurance recoveries which relate to cleanup costs incurred in 1991.

According to Minnegasco, equity demands that shareholders should be allowed to keep the reimbursement for 1991 MGP costs the shareholders sustained. Minnegasco noted that $710,000 in MGP cleanup costs were incurred in 1991, while the maximum amount that could arguably be said to have been recovered in rates was $250,000. Shareholders have paid the balance of 1991 MGP costs and should not be denied recovery of the insurance reimbursement through placement of the funds in the environmental tracker.

Minnegasco argued that the 1995 decision denying the Company the right to recover 1991 MGP costs is not precedent here because that decision was based on the Company's failure to ask in advance for Commission approval of the deferral and recovery of the costs. According to Minnegasco, it is no longer making the same mistake and should not be penalized by the inclusion of the related insurance recoveries.

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[8] In the Matter of the Request of Minnegasco for Approval of Its Annual Manufactured Gas Plant Update Compliance Filing.

b. The Department

The Department argued that insurance recoveries related to 1991 MGP costs should be placed in the environmental tracker. The Department cited the 1995 accounting Order, in which the Commission denied Minnegasco's proposal to use its nondeferred 1991 costs to offset related insurance cost recoveries. The Department stated that that Order demonstrated the Commission's intent to include all of Minnegasco's 1991 MGP-related insurance recovery proceeds in any type of deferred account or tracker. The Department rejected the Company's fairness argument, stating that the Company had overrecovered MGP costs from ratepayers in years prior to 1991.

c. The ALJ

The ALJ agreed with the Department that the $272,448 in 1991-related insurance recoveries should be placed in the environmental tracker. The ALJ stated that the Commission had settled this issue in the September 22, 1995 decision on MGP costs. A departure from that Order would require a definite Commission policy change. The ALJ did not recommend such a change.

3. Commission Action

The Commission agrees with the Department and the ALJ that Minnegasco's 1991-related MGP insurance recoveries must be placed in the environmental tracker.

Since 1992, Minnegasco has been placing MGP cleanup costs and associated recoveries in a special deferred account. As agreed upon by the parties to this rate case, Minnegasco will now be placing the environmental costs and recoveries in an environmental tracker. No party has objected to the basic elements of Minnegasco's previous deferral or future tracking.

The presumption, therefore, is that any MGP insurance recovery will be deferred or tracked alongside MGP costs for future consideration in the setting of rates. Omission of 1991-related insurance recoveries would require a specific, acceptable reason for the departure from agreed-upon procedure.

In 1995, Minnegasco attempted to mitigate the inclusion of 1991-related insurance recoveries by offsetting them with 1991 MGP costs--costs which the Commission had previously said could not be deferred for rate case consideration. The Commission rejected the proposal, stating that the offset would in effect rescind the Commission's prior denial of deferral authority. The 1991-related insurance recoveries stayed in the deferred account and the 1991 MGP costs stayed out.

Minnegasco is now asking that post-rate filing 1991-related insurance recoveries stay out of the environmental tracker. The Company offers two reasons to keep the recoveries out of consideration: fairness requires this measure, and a previous related Commission decision does not apply.

Minnegasco's fairness argument is a reconfiguration of its proposal to consider non-deferred 1991 costs--a proposal that the Commission rejected in the 1995 accounting Order. The Company argues that the fact that 1991 costs were excluded from consideration in ratemaking means that the costs were borne by shareholders. The Company concludes that "fairness" dictates exclusion of the associated recoveries from the tracker, so that shareholders who have borne the cost get the benefit of the offset.

Minnegasco's fairness argument ignores the fact that the Commission has previously addressed and rejected its proposal to include non-deferred 1991 MGP costs in ratemaking consideration. This issue is settled and cannot be revived by a restated argument. Minnegasco's fairness argument does not provide a reason to deviate from the usual inclusion of MGP insurance recoveries.

The Commission is also unpersuaded by Minnegasco's argument that the precedent from the 1995 deferral decision does not apply to this situation. According to Minnegasco, the Commission's rejection of the Company's proposal to include 1991 costs in MGP deferred accounting was based on the fact that the Company had not obtained prior approval for the deferral. The Company states that the facts are now different because it "has not made that same mistake here." The Commission disagrees: the fact that the Company is asking in advance for exclusion of the 1991-related cost recoveries does not legitimize an indirect "resurrection" of 1991 nondeferred costs by excluding cost recoveries typically included in a tracker. The Commission's current decision to include the 1991-related MGP cost recoveries in the environmental tracker is consistent with its decision in the 1995 accounting Order.

The Commission adopts the findings and recommendation of the ALJ on the inclusion of 1991-related MGP cost recoveries in the environmental tracker.

B. Environmental Expense--Tracker Account

Although this item is not a contested financial issue, the Commission will discuss it in this section of the Order because it relates to the prior and subsequent subsections.

1. Positions of the Parties; the ALJ

a. Minnegasco

The Company proposed that a tracker account be established to account for environmental costs and recoveries. Costs incurred by Minnegasco for environmental cleanup, including outside legal help, investigation, and remediation, would be recorded in this account. Cost recoveries, such as rate recovery, insurance, and third-party recovery would also be recorded to this account. The amount of environmental costs recovered in rates to enter to the tracker account would be determined by developing an Environmental Cost Recovery Charge (ECRC). The ECRC would be calculated by dividing test year environmental costs by test year sales volumes.

The Company argued that the tracker account method is superior to the deferred accounting method used in the prior Minnegasco rate case. The deferred method does not relate costs recovered in rates to actual sales. The tracker method will also assist in assuring that ratepayers pay no more nor less than the costs actually incurred.

b. The Department

The Department supported the establishment of an environmental tracker account, citing the uncertain nature of environmental costs. The use of the tracker mechanism will alleviate problems resulting from the difficulty of estimating costs and recoveries.

c. The ALJ

The ALJ determined that the environmental costs fluctuate by nature. The use of an environmental tracker would lead to a better matching of costs and recoveries. This would avoid either over collecting or under collecting for the costs.

2. Commission Action

The Commission agrees with the parties and the ALJ that the use of a tracker account will provide a reasonable mechanism to account for the costs and recoveries of environmental costs. Due to the uncertainty of the level of costs which will ultimately be incurred for environmental costs, the Commission is concerned that mechanisms be put into place which will assure that prudent environmental costs be recovered, no more nor less. The Commission will direct the establishment of the tracker account effective October 10, 1995.

The ECRC concept will relate rate recovery of costs to the actual sales volumes realized. Instead of establishing a fixed test year recovery amount, the ECRC will establish recovery based on actual sales. In years of increased sales, such as the current year, increased collections will be recorded in the account. In years where sales may lag, decreased collections will be recorded in the account. This will facilitate achieving the goal that reasonable costs are recovered. The Commission will direct Minnegasco to supply the ECRC, showing all calculations, with the compliance filing in this proceeding.

Further, the tracker account is a mechanism which will preserve an opportunity to review all costs and recoveries entered to the account for prudence and reasonableness.

Because of the high costs involved in the cleanup of various environmental sites, the substantial legal costs incurred, and the possibilities of substantial insurance recoveries, the Commission does not feel comfortable with simply establishing the tracker account and waiting for the next rate case to review the progress. In order to maintain a higher level of scrutiny, the Commission will require the Company to report annually on the status of the tracker account. Such report shall include a detailed summary of all entries and assumptions in arriving at the then current balance. The report shall also forecast expected results for the future year as well.

Finally, the Commission directs Minnegasco to include in its compliance filing detailed descriptions of the expected accounting entries in this account. The filing should include the accounting treatment of deferred costs, recoveries, carrying charge rate, carrying cost calculations, etc. Receiving this information with the compliance filing in this proceeding will allow parties the opportunity to review the details of the proposed accounting before misunderstandings may develop.

C. Carrying Charge on the Environmental Tracker Balance

1. Positions of the Parties; the ALJ

a. Minnegasco

The Company proposed that it be allowed to calculate and record a carrying charge on the balance in the tracker account. The carrying charge was proposed as the pre-tax rate of return finally awarded in this proceeding.

The Company maintained that it would be inconsistent to establish a tracker account mechanism for the purpose of achieving greater matching of expenses and recoveries, yet disallow a carrying charge. Permitting a carrying charge assures that neither the Company nor the ratepayer will be unfairly financing the balance in the tracker account.

b. The Department

The Department recommended that no carrying charge be allowed on the tracker balance. Further, the Department recommended that the test year deferred balance be removed from rate base.

The Department argued that the Commission disallowed carrying costs in prior Minnegasco cases and, more recently, in the Interstate rate case, Docket No. G-001/GR-95-406.

c. ALJ

The ALJ recommended that the requested carrying charge be disallowed. The ALJ cited the recent Minnegasco rate case where the Commission indicated that it generally does not allow carrying costs on manufactured gas plant (MGP) cleanup costs. Also, the ALJ noted that a long deferral period is not an issue in this case, citing the fact that there would be no deferred debit to carry forward if the Department's adjustments are accepted.

2. Commission Action

The Commission will allow carrying charges in this case. Further, the Commission will remove the deferred balance included in the originally filed rate base. This reduces test year rate base by $912,000.

The Commission recognizes that it has not generally allowed carrying charges on deferred MGP cleanup costs. The Commission has always maintained, however, that it has the discretion to decide on a case by case basis if carrying costs should be allowed, and if they should, at what rate and over what period of time. Further, many of the facts in this case are somewhat atypical. First, much of the environmental costs at issue in this proceeding have been subjected to review in more than one rate proceeding. The costs have been shown to be substantial. Second, the Commission has accepted the stipulation of Minnegasco and the Department and established the test year cost at an amount approaching $7 million. Third, the Commission has departed from the usual deferred accounting mechanism and has directed that a tracker mechanism be established, with the amount recovered in rates tied to the sales volume through the ECRC. Fourth, the Commission has indicated a desire that the cleanup costs be recovered, no more nor less. Finally, the Company has shown that its aggressive pursuit of insurance recoveries has produced some significant recoveries.

The costs and recoveries are also beginning to display significant volatility. These factors will lead to the possibility of swings in the tracker balance from large amounts owed to the Company to large amounts owed to the ratepayers. To assure that neither the Company nor the ratepayers are unduly financing the tracker balance, the Commission will direct that the Company record a carrying charge on the monthly tracker balance based on the pre-tax rate of return approved in this proceeding.

Finally, the Company witness testified at hearing that it is not the intent of Minnegasco to earn a rate of return on the deferred balance and also a carrying charge on the tracker balance. The witness testified that upon approval of the tracker mechanism and carrying charge, the Company would transfer the deferred balance to the tracker account. A carrying charge would then be calculated on the tracker balance on a prospective basis. The Commission will reduce rate base by $912,000 to remove the deferred amount included in the originally filed test year rate base.

D. CIP Test Year Expense

1. Positions of the Parties

a. Minnegasco and the Department

In its original filing, the Company proposed a test year expense of $7,862,104 for conservation improvement expense (CIP). The Company indicated in its rebuttal testimony that it is appropriate that the test year level of CIP expense reflect the approved level at the time of final rates. The Department also recommended that the test year level of CIP expense be set at the most recently approved CIP budget level at the time of the Commission's deliberations.

2. Commission Action

The Commission agrees that setting the test year CIP expense to reflect the most recently updated CIP budget level is appropriate. Establishing the test year expense to coincide as closely as possible with the actual approved CIP budget will result in a level of CIP recovery included in rates which will most closely match the expected expenditures. This should minimize the amount of balances accumulating in the CIP tracker account.

The most recently approved CIP budget is reflected in a Department letter dated April 3, 1996. That letter established a CIP budget of $6,983,287. The Commission will decrease test year CIP expense by $878,817 to reflect the updated budget.

Additionally, it is necessary that a conservation cost recovery charge (CCRC) be calculated. The CCRC is used to calculate the level of revenues credited to the CIP tracker account. The CCRC is calculated by dividing the test year CIP expenses by the test year sales units finally approved in this proceeding. The Commission will direct Minnegasco to supply its calculation of the CCRC with its compliance filing in this proceeding.

E. CIP Tracker Balance

1. Positions of the Parties; the ALJ

a. Minnegasco

The Company originally projected a CIP tracker balance of $1,426,216 at the beginning of the test year. The Company proposed a two-year amortization of the balance, with $1,070,000 of the unamortized balance included in the rate base. The Company included $713,108 as test year expense.

In rebuttal testimony, the Company agreed that the tracker balance would be adjusted to reflect the actual balance and that the balance would be recovered from the interim refund due, or added to the interim refund if the tracker balance is a negative amount. If the refund is insufficient to recover the CIP tracker balance, the Company proposed that the residual be amortized over two years with the unamortized balance in rate base. The Company argued that, if the tracker balance is zeroed out through the interim refund, the tracker balance should be zeroed out at the time final rates are effective instead of at the beginning of the test year.

b. The Department

The Department recommended that the CIP tracker balance be adjusted to reflect the $711,776 actual negative balance as of September 30, 1996. The Department also recommended that this amount be added to the interim refund and returned to ratepayers and that the amounts included in test year expense and rate base be removed. The Department opposed zeroing the CIP tracker balance at the time of final rates, and opposed the inclusion of the unamortized balance in rate base in the event that the CIP tracker balance at the time of final rates would exceed the interim refund.

c. The ALJ

The ALJ recommended that the CIP tracker balance at the time of final rates be added to or subtracted from the interim refund.

2. Commission Action

The Commission agrees with the ALJ's recommendation to include the CIP tracker balance at the time of final rates in the interim refund.

The Commission recognizes that it has zeroed CIP tracker balances as of either the beginning or the end of test years in various rate cases, according to the facts in each case. While it is desirable to use the beginning balance, circumstances unique to the current proceeding convince the Commission to make the zero-out effective as of the time final rates are implemented. In this case, there is a substantial negative balance at the beginning of the test year. That negative balance may become an even larger negative balance when the CIP revenue recoveries for the colder-than-normal winter are factored in.

When addressing CIP tracker balances in rate proceedings, the Commission attempts to zero-out the balance as closely as possible. The Commission is convinced that zeroing the balance at the time of final rates, as was done in prior Minnegasco proceedings, will achieve that goal in this proceeding.

Because it does not appear that there will be a CIP tracker balance due which would exceed the interim refund available, the Commission will not address at this time whether or not an unamortized CIP tracker balance shall be included in rate base.

The Commission will direct Minnegasco to supply the CIP tracker balance at the time of final rates, and supporting calculations, with its refund plan in this proceeding. Parties will have the opportunity to review the balance and calculations at that time.

Because the Commission will require that the tracker balance be zeroed through the refund in this proceeding, the Commission will remove the tracker amortization ($713,108) from the income statement, and the unamortized balance ($1,070,000) from rate base.

F. Compressed Natural Gas Investment

1. Positions of the Parties; the ALJ

a. The Department

Minnegasco refuels its fleet of compressed natural gas (CNG) vehicles at the Company's South Fueling Station facility. Minnegasco included as rate case items the costs of capital investment and expenses associated with the South Fueling Station.

The Department urged the Commission to disallow most costs associated with Minnegasco's South Fueling Station facility. The Department's recommendation would reduce rate base by $348,000 (the capital investment for the fueling station, land, and related deferred tax balance) and increase test year net income by $17,000 (reflecting sales, expenses, and depreciation associated with the refueling station).

The Department acknowledged that Title V of the Federal Energy Policy Act requires that 30% of Minnegasco's new light duty vehicles must be alternative fuel vehicles, and did not dispute the number or type of the Minnegasco vehicles. The Department agreed that the Company could include in rate base the conversion-kit costs associated with converting new vehicle purchases to CNG.

The Department did not agree that the Company should include the capital investment or expenses for its South Fueling Station. The Department argued that the facility is open to the public and should be considered a competitive enterprise; as such, its costs should not be included in regulated rates. The Department also argued that the property was not used and useful because the Company refueled at the facility by choice--the investment in the facility was not necessary for the provision of utility service. Finally, the Department argued that costs should be disallowed because the Company had not provided a cost/benefit analysis to show that costs of refueling at its own facility were less than refueling at a public station.

b. Minnegasco

Minnegasco opposed the exclusion of its CNG refueling station expenses and capital investment. The Company noted that there is no dispute regarding the percentage of alternative vehicles Minnegasco must use, or the choice of CNG vehicles to fulfill the federal mandate. Minnegasco noted that it had agreed to exclude the portion of the facility used by the public from consideration in rate base or expenses. After removal of the costs associated with service to the public, what remains is clearly cost associated with utility service.

Minnegasco stated that it clearly must fuel its CNG vehicles. By refueling at its own facility, the Company is able to obtain fuel at cost, where the vehicles are stored, in off-hours. By contrast, the closest public refueling facility is located some distance from the vehicle storage site. If refueling at a public facility, the Company would be required to refuel during normal business hours, at the going market price. Choice of a public refueling site would therefore result in significant vehicle down-time and higher fuel prices. Minnegasco argued that the refueling facility is clearly used and useful for the prudent provision of utility service.

c. The ALJ

The ALJ agreed with the Department that costs associated with the South Fueling Station should be excluded. The ALJ stated that Minnegasco had failed to prove by a preponderance of the evidence that the South Station was used and useful or reasonably necessary for utility service. According to the ALJ, the Company had also failed to prove that choosing to refuel at its own facility rather than a public facility was cost-efficient.

2. Commission Action

The Commission agrees with Minnegasco that the costs of investment in the South Fueling Station should be recovered in rates.

Minnegasco has acted under federal mandate to create and maintain an alternative fuel fleet. The vehicles must be refueled, either at a public facility or Minnegasco's refueling facility. Minnegasco has demonstrated by factual comparison that the choice of refueling at its own facility is a prudent managerial decision in this case.[9]

The Department's concerns regarding CNG investment costs seem to arise from the fact that the facility is also used to provide competitive service. The Commission notes that utilities can and do combine regulated and nonregulated service. Such combined enterprises are likely to become more common as the gas utility industry opens to more competitive options. The use of a facility for both regulated and nonregulated use is proper *so long as ratepayers do not subsidize the competitive enterprise*. Here, all costs associated with provision of fuel service to the public have been removed from rate case consideration.[10] What remains is the cost of constructing and maintaining a refueling facility for the Company's regulated provision of service. Maintaining the Company's federally mandated fleet is clearly a benefit to ratepayers and the costs of the refueling facility should be included in rates.

If the Department has specific concerns regarding ratepayer subsidization of the South Station, the Department may provide evidence of the cross-subsidization in future proceedings. No such evidence was submitted in this rate case.

Minnegasco has met its burden of demonstrating that its South Fueling Station is used and useful for the normal provision of utility service. Use of the facility was a prudent managerial decision and associated costs were prudent and reasonable. The Commission will allow recovery of the proposed costs in rates.

G. LIHEAP--Evidentiary Issue

1. Positions of the Parties; the ALJ

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[9] The Commission disagrees with the Department that Minnegasco's *choosing* to refuel at its own facility means that the property was not necessary for the provision of service and should be excluded from rate base. Rate case analysis does not require a utility to demonstrate that plant investment took place because other viable choices did not exist. The utility must prove that the choice resulted in property which was used and useful and provided a benefit to ratepayers, and that associated costs were prudently and reasonably incurred. Minnegasco has demonstrated these facts in this case.

[10] The Commission notes that Minnegasco agreed to remove from rate case consideration the portion of the facility used to fuel non-Minnegasco (public) fleets. This results in a reduction in rate base of $59,000 and an increase in test year net income of $1,000.

a. Minnegasco

Minnegasco's rate case was filed on August 11, 1995. In December, 1995, and again in January, 1996, Minnegasco offered updated evidence of Congressional cuts in the Low Income Home Energy Assistance Program (LIHEAP). Minnegasco also offered its quantification of the impact of the program cuts on Minnegasco's revenues. The new information was offered in Minnegasco's Exhibits 24 and 27.

Minnegasco argued that the updated evidence on projected bad debt expenses was necessary for the Commission to set just and reasonable rates. According to Minnegasco, the information was necessary to answer LIHEAP issues touched on by the Energy CENTS Coalition witness. The Company also argued that the projected $4.5 million increase in required revenue would not exceed the original filed revenue request, because of the other decreases which had been settled or stipulated to.

Minnegasco argued that the ALJ and the Commission can and should take official notice of Congressional action and apply the percentage decrease in LIHEAP funding as a measure of the expected increase in bad debt and related expenses.

Minnegasco submitted a Motion to Admit Evidence and Offer of Proof, seeking admission of the late-filed LIHEAP evidence.

b. The Department, RUD-OAG, and Energy CENTS

The Department stated that the LIHEAP evidence in Exhibits 24 and 27 should not be entered into the record. The Department argued that the testimony is speculative, especially regarding the Company's allegations of a one-to-one relationship between LIHEAP funding and bad debt expense.

The RUD-OAG and the Energy CENTS Coalition also objected to inclusion of the late-filed LIHEAP testimony.

c. The ALJ

The ALJ excluded Minnegasco's Exhibits 24 and 27 from the record. The ALJ stated that the documents are speculative because they purport to know what the U.S. Congress and the Minnesota legislature will do regarding the LIHEAP issue. If the evidence is offered as direct testimony, it is improper because it was not filed as part of the Company's direct case. If the exhibits are offered as rebuttal testimony, they are not proper because they do not "rebut" the Energy CENTS testimony regarding rate design issues. The ALJ also stated that it is inappropriate for Minnegasco to amend its rate filing by approximately $4.5 million dollars several months after the case was filed. According to the ALJ, a proposal to increase the revenue requirement by $4.5 million is disruptive to the expedited hearing process and in potential violation of Minn. Stat. § 216B.16, subd. 5, which prohibits a rate increase above the original filed request.

2. Commission Action

The ALJ has offered sound reasons for his rejection of the late-filed testimony on LIHEAP funding. The Commission agrees with the ALJ that the proffered evidence is speculative, improperly filed, and disruptive of the hearing process. The Commission finds no reason to contravene the ALJ's decision, or to take judicial notice of the Company's speculative testimony on the financial impact of program cuts.

The Commission adopts the ALJ's finding regarding the exclusion of Minnegasco's Exhibits 24 and 27.

H. Incentive Compensation

1. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco's total compensation program is structured on base salary and compensation based on incentives. The Company's incentive awards are based on the achievement of a combination of Company and individual goals.

Two of Minnegasco's incentive compensation plans were issues in the rate case. Under the Officers' Annual Incentive Compensation Plan (AICP), the amount earned is based one-half on the achievement of Minnegasco's financial and customer service goals and one-half on achievement of NorAm's consolidated performance measures. NorAm's three performance measures are earnings per share, return on capital employed, and net cash flow from operations. Under the Officers' Long-Term Incentive Plan (LTIP), the awards are based on a rate of return determined from a composite ranking of other transmission and distribution companies and NorAm's stock price.

Minnegasco urged the Commission to allow recovery of all incentive compensation costs, including the AICP and LTIP, in rates. The Company argued that its overall employee compensation level is 90.6% of market; if the total compensation is reasonable, the incentive compensation portion should also be considered reasonable. The Company also argued that both shareholders and ratepayers benefit if the financial goals of the Company's incentive program are met. Benefits to ratepayers would include longer periods between rate cases with smaller rate case increases, and lower capital costs for the utility.

Minnegasco stated that it had fulfilled the requirements the Commission set out in the Company's last rate case, Docket No. G-008/GR-93-1090. First, Minnegasco had demonstrated that all incentive compensation earned under the terms of Minnegasco's plans had been paid. Second, Minnegasco had provided a detailed description of its incentive compensation plan.

b. The Department

The Department recommended that the Commission disallow all cost recovery for the LTIP, which is based entirely on achievement of corporate financial goals, and 75% of the AICP, which is based mostly on corporate financial goals and partially on customer-oriented criteria: performance for customer satisfaction, and operating and maintenance per customer.

The Department agreed with the Company that its overall level of compensation is reasonable and that rate recovery of the full amount would be appropriate if it were distributed through base pay rather than incentive compensation. However, the Department contended, these points are not relevant to consideration of the Company's incentive compensation plans as they are presently structured. According to the Department, the difference is the fact that a base pay formula would be based on the individual's personal performance in the job, whereas the two incentive compensation plans are based on the achievement of financial goals that primarily benefit shareholders.

The Department stated that it was guided by the Commission's consideration of Northern States Power's (NSP's) incentive compensation plan in NSP's 1993 rate case, Docket No. E-002/GR-92-1185[11]. In its final Order and reconsideration Order in that case, the Commission expressed its strong disapproval of NSP's high percentage (up to 30 and 40 percent) of executives' and officers' pay based on incentive compensation. The Commission limited recovery of incentive compensation costs to 15 percent of base salary for executives and officers.

The Department noted that officers can receive up to 48 percent of base pay in incentive compensation under Minnegasco's plans; ratepayers will be asked to fund up to 30 percent of an officer's base pay under the AICP. The Department argued that the Company has failed to show that reward to ratepayers follows this high level of risk. Incentive goals based on financial performance are geared to the interests of shareholders, not ratepayers.

c. The ALJ

The ALJ adopted the recommendation and reasoning of the Department. The ALJ stated that the Company's below-market overall level of compensation is not dispositive in this case because the Company has failed to prove that ratepayers' interests are being served by the AICP and LTIP incentive compensation plans.

2. Commission Action

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[11] In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 29, 1993); and ORDER AFTER RECONSIDERATION (December 30, 1993).

a. Past Commission Treatment of Incentive Compensation

The Commission addressed the issue of incentive compensation for officers and executives in the 1993 NSP electric rate case, Docket No. E-002/GR-92-1185. In the final Order in that case, the Commission noted the acceptable criteria of an incentive compensation plan--quantifiable goals relating to safety, customer satisfaction, productivity, cost control, and individual employee performance. However, the Commission disallowed cost recovery for NSP's particular incentive package because of defects in the program, considered in conjunction with the Company's overall high level of compensation. The Commission noted as defects the improper transfer of risk from shareholders to ratepayers, the inappropriate reliance on financial goals, and the high ratio of incentive compensation to total employee compensation.

> A major reason the Commission rejected the Company's 1991 incentive compensation plan was a Commission finding that the plan improperly transferred risks of operation from shareholders to ratepayers and Company employees. (Cite omitted.) This defect was more obvious in the 1991 plan, which made all incentive plan payments contingent upon company earnings meeting a specified earnings per share threshold. The current plan, however, retains an earnings per share component in the officers' and executives' plan and in the long-term plans, which are available only to officers and executives. (Footnote omitted.) The Commission continues to consider earnings per share thresholds an improper transfer of risk, since ratepayers bear the risks (the costs of incentive compensation) and shareholders reap the benefits (increased earnings per share).
>
> The Commission also continues to believe earnings per share thresholds can jeopardize a utility's commitment to providing safe, reliable, economical service over the long-term by over-emphasizing short-term performance. In most private business contexts, short-term thinking is merely unfortunate. In the public utility context, it can create a public crisis.
>
> Another defect in the plan is the large percentage (up to 30 percent and 40 percent) of executives' and officers' pay which can come from incentive compensation. These percentages are simply too high. Their stated purpose is to align officers' and executives' interests more closely with those of shareholders. While officers and executives clearly have a duty of loyalty to shareholders, they also have a duty to exercise independent judgment on behalf of the Company and to give regulators their full cooperation. Offering key decisionmakers large financial rewards for producing short-term shareholder benefits does not promote regulatory efficiency or the long-term fortunes of the Company. Since the public has an interest in ensuring the long-term viability and stability of the Company, this is a serious defect.
>
> Order at pp. 28-29.

Upon reconsideration in the NSP rate case, the Commission expressed less concern about the Company's overall level of compensation, and modified its previous decision by limiting rate recovery for incentive compensation costs to 15 percent of the officer's base salary. The Commission continued, however, to express its reservations about the perceived defects in the plan. The Commission stated that it would continue to develop and analyze these issues, including the use of earnings per share as an incentive.

The Commission next considered the issue of incentive compensation for executives and officers in the October 24, 1994 Minnegasco rate case decision. In that proceeding, the parties came to an agreement upon the level of incentive compensation to be placed in rates and stipulated to the agreement. The Commission accepted the parties' stipulated figures, but continued to express reservations about the level and structure of incentive compensation plans.

> The Commission has found that incentive compensation plans can be effective management tools when properly designed and administered. At the same time, the Commission has expressed concern about their potential, if poorly designed or administered, to work to the detriment of ratepayers. (Cite omitted.)
>
> Poorly designed incentive compensation plans can promote short-term thinking, exacerbate conflicts of interest between shareholders and inappropriately shift financial risk from shareholders to ratepayers.
>
> *****
>
> ...[W]hile total compensation amounts are important in evaluating the reasonableness of any incentive compensation plan, even a plan yielding below-market wages can be so ill-conceived or badly administered that it jeopardizes ratepayer interests. It can, for example, link such a high percentage of salary to short-term corporate financial gains that it compromises quality of service. For these reasons, the Company's low overall salary levels should not permanently shield its incentive compensation program from review.
>
> To ensure comprehensive review of the Company's incentive compensation program in the future, the Commission will require the Company to include in its next rate case filing a detailed description of its incentive compensation program. This will permit the comprehensive review necessary to ensure that the plan does not contain disincentives to regulatory compliance, long term planning, and similar values unique to companies providing essential services in a monopoly environment.
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> Order at pp. 11-12.

b. Summary of Commission Action on Minnegasco's Incentive Compensation Plan

The Commission now has before it a fully detailed and developed description of the portion of Minnegasco's compensation plan reserved for officers and executives. The Commission also has the benefit of the Department's investigation and the ALJ's analysis and recommended decision. The Commission is able to consider the full impact of the Company's plans in light of the Commission's policy as expressed in prior Orders.

The Commission notes that the level and structure of incentive compensation plans are inextricably tied. Companies strive to design plans' monetary levels and performance criteria to move employees' efforts toward goals the Company has deemed worthy. In its case by case analyses of utilities' incentive compensation plans, the Commission will always carefully consider both the level and the terms of the particular plan.

Having considered the percentage of Minnegasco's total compensation hinging on achievement of incentives, plus the focus of the plans' particular incentives, the Commission agrees with the Department and the ALJ that most costs of the Company's AICP and LTIP plans must be disallowed. The Company in this instance has failed to achieve the delicate balance of risk and reward, performance and appropriate incentive, that is the characteristic of an acceptable plan.

c. Commission Finding

Analysis of the level of Minnegasco's incentive compensation shows that participants in the AICP plan can attain 48% of their base pay through incentives. The rate recovery anticipated by the Company is approximately 25% (in one case up to 30%) of base pay, a level well above the 15% approved by the Commission in the NSP rate case. The fact that incentive compensation is such a high percentage of overall compensation is a warning flag for the Commission--executives and officers will be extremely focused on the achievement of the program goals. The Commission must therefore scrutinize the choice of incentives very critically.

The incentives of the AICP plan are only minimally tied to direct ratepayer benefits (the performance for customer satisfaction and operating and maintenance per customer elements). The remaining, major portions of the plan incentives are based on Minnegasco's, and even more remotely, NorAm's financial performance measures. The LTIP plan is totally tied to non-consumer factors--the rates of return of analogous gas companies and NorAm's stock price.

Given the percentage level of incentive compensation, the Commission finds that the incentives built into these plans are not appropriate. An incentive compensation plan such as Minnegasco's is a powerful tool. No matter what part of the plan is recoverable in rates, the fact is that almost half of the salaries for executives and officers are determined by the plans' goals. The level and structure of these particular plans are likely to lead officers to focus their energy on corporate balance sheets rather than the judgments and decisions which can directly affect ratepayer service and satisfaction. In situations in which short-term financial goals may conflict with the long-term policies necessary to achieve safe, reliable, and reasonable service, officers will be financially rewarded by seeking the short-term financial goal.

The Commission's disallowance of the costs of these programs is not meant to discourage incentive compensation plans that are appropriately designed to stimulate employee creativity, productivity, and loyalty. Disapproval of the particular structure and terms of these plans does not mean that the Commission should, or wishes to, design utility compensation programs in the future. This disallowance simply means that in this particular case, where the plan forms a very high percentage of total compensation, and the program incentives are questionable, the Commission will disallow all costs except the small percent tied to direct ratepayer benefit.

The Commission adopts the reasoning and findings of the ALJ on incentive compensation. This will reduce rate base by $234,000 and increase net income by $202,000.

I. The Midwest Gas Acquisition Adjustment

1. Background

The acquisition adjustment at issue stems from the exchange of properties between Minnegasco and Midwest. In that exchange, Minnegasco exchanged its South Dakota properties for Midwest's Minnesota properties. The exchange was effective on September 1, 1993.

In the exchange, Minnegasco indicated that it gave up property valued at $22.7 million and cash of $38.8 million, and assumed liabilities of $1 million. Minnegasco received property valued at $46.5 million. After consideration of some miscellaneous liability exchanges, Minnegasco recorded a total acquisition adjustment of $14,866,323.

Minnegasco included schedules calculating the annual cost of the acquisition adjustment as $3,091,854. This included return on the unamortized balance, taxes on the return, property taxes, and the amortization.

Minnegasco withdrew the acquisition adjustment issue without prejudice as part of the settlement in Minnegasco's most recent rate proceeding, Docket No. G-008/GR-93-1090.

2. Minnegasco

The Company proposed to include $978,685 as test year expense as an amortization of the acquisition adjustment ($503,562) and related property taxes ($475,123).

Minnegasco reasoned that the $978,685 amount included in the test year is appropriately recovered because it represents the amount of non-gas benefits realized by Minnegasco's ratepayers as a result of the acquisition of Midwest by Minnegasco. In arriving at the $978,685 amount, the Company projected approximately $3.1 million in ratepayer benefits based on the average of three scenarios, each assuming some level of rate adjustment by Midwest in 1994 in the absence of the acquisition by Minnegasco. After reducing the $3.1 million amount of estimated benefits for former Midwest customers by the increase in costs to prior Minnegasco customers of approximately $2.1 million, the Company cited $978,685 of net ratepayer benefits which should be allowed as a recovery of the acquisition adjustment.

3. Comments of the Parties

The Department and the SRA recommended that the proposed recovery of acquisition adjustment be disallowed.

The Department argued it was unlikely that the former Midwest would have sought a rate change in 1994. The Department reasoned that because Midwest agreed to a three-year amortization of its rate case expenses for its 1992 rate proceeding, Midwest would not have sought a rate change until at least 1995. Further, the Department argued that it was much too speculative for Minnegasco to project what increase Midwest would have sought and what portion of that increase would have been allowed by the Commission in an actual rate proceeding.

Arguing that the existing Midwest rates from the 1992 rate proceeding are the only rates which can be determined with any certainty, the Department calculated a benefit to the former Midwest customers of only about $2 million, less than the amount of increased costs to the prior Minnegasco customers. This results in no net benefits and no acquisition adjustment can be allowed.

The SRA also argued that benefits to ratepayers were largely speculative, unsupported by item-by-item cost analysis. The SRA also argued that, if the acquisition adjustment were allowed, only the former Midwest customers should be required to pay. They are the only customers that realized benefits from the acquisition. Prior Minnegasco customers already realized increased costs as a result of the acquisition of Midwest.

4. The ALJ

The ALJ recommended that the proposed recovery of the acquisition adjustment be denied. The ALJ found that Minnegasco's macro approach fails to identify ratepayer benefits as a result of the acquisition, that the claimed savings are speculative, and that the Company did not begin to satisfy the conditions for allowing an acquisition adjustment to be recovered as identified by the Commission in the 1991 Midwest rate case, Docket No. G-010/GR-90-678.[12]

The ALJ summarized those conditions as (a) a utility must demonstrate benefits to ratepayers; (b) the benefits would not have occurred but for the acquisition; (c) the benefits are quantifiable; (d) the benefits to ratepayers are greater than the cost of the acquisition adjustment, and; (e) there will be ongoing ratepayer benefit realized over time.

The ALJ found that the Company's macro assessment did not identify benefits because no savings were identified for any individual cost components as a result of the acquisition. No qualitative benefits such as enhanced conservation, greater environment quality, safety, or new systems and

[12] In the Matter of the Application of Midwest Gas, a Division of Iowa Public Service Company, for Authority to Change Its Schedule of Gas Rates for Retail Customers within the State of Minnesota, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (July 12, 1991).

programs were identified.

According to the ALJ, even if the macro approach identifies a benefit to customers, Minnegasco's quantification is based largely on speculation.

5. Commission Action

The Commission adopts the recommendations of the Department and the ALJ and will reject the inclusion of the proposed acquisition adjustment amount in rates.

The Commission finds that the Company has not adequately supported its request to include the acquisition adjustment in rates. As indicated by the ALJ, Minnegasco did not identify qualitative benefits to customers. As the Department showed, the Company's efforts to show benefits continue to the present time were flawed because the Company failed to similarly inflate sales volumes when inflating Midwest's costs to 1996.

The Commission finds that the Company depended heavily on the assumption that Midwest would have requested a rate change in 1994. This assumes that Midwest would have sought a rate increase, that Minnegasco can identify what that rate request would have been, and that Minnegasco could predict what amount of that increase request would have been awarded by the Commission. It must be recognized that rate proceedings have resulted in zero increases, and in at least one instance, a rate decrease. To assume a given level of rate increase in 1994 is highly speculative.

The Commission notes that the Department conducted a cost-benefit analysis using the Midwest rates approved in the 1992 Midwest rate proceeding, Docket No. G-010/GR-92-710, absent the speculative rate adjustments proposed by the Company. Under this scenario, the Department calculated that the costs to the then existing Minnegasco customers exceed the benefits to the Midwest customers, showing a net cost to ratepayers resulting from the acquisition of the Midwest properties. The rates established in the 1992 rate proceeding are known, requiring no speculation. The rates established in the 1992 proceeding are just and reasonable until shown that they no longer are just and reasonable.

The burden to show that costs are reasonable rests with the Company. Minn. Stat. 216B.16, subd. 4 provides that the burden of proof to show that a rate change is just and reasonable is on the utility seeking the change. Further, Minn. Stat. 216B.03 provides that any doubt as to reasonableness should be resolved in the favor of the consumer.

The Commission concludes that the prerequisites for allowing recovery of an acquisition adjustment in rates identified by the Commission in its Order in the Midwest rate case docket are equally applicable to this fact situation, and have not been satisfied. Further, the Commission concludes that Minnegasco has not met its burden of proof through the speculative approach offered in this proceeding. As a result, the Commission will reject Minnegasco's request to include a portion of the acquisition adjustment in the test year.

XVIII. RATE OF RETURN

A. Introduction

The overall rate of return represents the percentage the utility is authorized to earn on its Minnesota jurisdictional rate base. The rate of return is determined by the capital structure, which is the relative mix of debt and equity financing, and the costs of these sources of capital. The Commission will first address the capital structure, then the costs of debt and the cost of equity. Finally, the Commission will put these factors together to derive the authorized overall rate of return on rate base.

Two parties submitted rate of return testimony in this proceeding. Dr. Bruce Fairchild testified for Minnegasco, and Dr. Luther Thompson for the Department.

B. Capital Structure

1. Positions of the Parties

Although Minnegasco is not a legal entity, it maintains a capital structure on its books and records that is separate from its parent company, NorAm. Minnegasco's booked equity consists of the amount of common stock, additional paid-in capital, and retained earnings existing at the date of the merger with NorAm, adjusted for any income earned and dividends paid to NorAm since that date. The amount of debt financing is based on agreements between NorAm and Minnegasco.

The Company proposed a capital structure consisting of 49.94 percent long-term debt, 1.90 percent short-term debt, and 48.16 percent common equity as shown below:

Capital	Amount (000s)	Percent
Long Term Debt	$178,029	49.94%
Short Term Debt	6,756	1.90%
Common Equity	171,693	48.16%
Total	$356,478	100.00%

The capital structure is based on the estimated average capitalization over the test year.

After comparing the Company's proposed equity ratio with that of comparable companies, the Department witness supported Minnegasco's proposed capital structure as being reasonable.

Both rate of return witnesses examined NorAm's capital structure for use in setting rates. Dr. Thompson concluded that using NorAm's capital structure would result in higher revenue requirements due to higher costs for each capital component in NorAm's capital structure. He argued that Minnegasco's ratepayers should not pay for the higher risk associated with NorAm's actions in areas other than natural gas distribution. Dr. Fairchild testified NorAm's capital structure is not appropriate for setting rates because it reflects NorAm's involvement in both gas distribution and, until recently, oil and gas exploration and production activities.

2. The ALJ

The ALJ found that Minnegasco's proposed capital structure was reasonable. He noted that the Company's equity ratio falls within a range of reasonableness for comparable gas distribution companies. Therefore, the proposed capital structure properly balances the interest of ratepayers and shareholders.

3. Commission Action

The Commission is charged with determining the most reasonable capital structure for Minnegasco for ratemaking purposes. In making this determination, the Commission finds that the relative proportions of the various forms of capital employed by the Company must be reviewed to ensure that ratepayers are not being required to pay an unnecessarily high cost of capital. The equity ratio is of particular concern. Because common equity is typically the highest cost capital, use of too much common equity in the capital structure could cause an excessive cost of capital. Conversely, a low common equity ratio could increase the risk that earnings will not be sufficient to pay fixed-cost obligations, causing other financing costs to rise.

The Commission must, therefore, be satisfied that the Company has established a capital structure that properly balances the needs of ratepayers for economy and the needs of investors for safety.

The Commission finds that the capital structure proposed by Minnegasco is reasonable, based upon the evidence in the record. Dr. Fairchild submitted evidence demonstrating that Minnegasco's equity ratio is slightly lower than the 50.4 percent average for the comparable group. Dr. Thompson found that the proposed equity ratio falls within the middle of the range of his comparable gas group.

In adopting Minnegasco's proposed capital structure for the test year, the Commission is not specifically endorsing Minnegasco's approach or advocating the use of a hypothetical capital structure for ratemaking as appropriate in all cases. The Commission continues to reserve its authority to examine a utility's capital structure and adjust it for ratemaking purposes where deemed necessary. The Company will be required to justify its proposed capital structure in future rate proceedings, and the Commission may adjust that capital structure if it finds that the Company's proposed capital structure is unreasonable for ratemaking purposes.

C. Costs of Long- and Short-term Debt and Preferred Stock

In its filing, Minnegasco proposed a test year cost of long-term debt of 8.7 percent and short-term debt of 6.4 percent.

No party challenged Minnegasco's costs of debt.

The Commission accepts the costs of long-term debt of 8.7 percent and short-term debt of 6.4 percent. The Commission concludes that these costs reasonably reflect the costs expected to prevail for Minnegasco during the test year.

D. Rate of Return on Common Equity (ROE)

1. Legal Guidelines for Commission Decision-Making

In reaching a decision on the appropriate cost of common equity, the Commission, as an administrative agency, must act both within the scope of its enabling legislation and the strictures of reviewing judicial bodies. Two United States Supreme Court cases provide these general guidelines for Commission rate of return decisions:

a. The allowed rate of return should be comparable to that generally being made on investments and other business undertakings which are attended by corresponding risks and uncertainties;

b. The return should be sufficient to enable the utility to maintain its financial integrity; and

c. The return should be sufficient to attract new capital on reasonable terms.

See Bluefield Water Works and Improvement Co. v. P.S.C., 262 U.S. 679 (1923), and FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

No particular method or approach for determining rate of return was mandated by those cases, but the necessity of a fair and reasonable rate of return was clearly stated:

> Rates which are not sufficient to yield a reasonable return on the value of the property used, at the time it is being used to render the service, are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. Bluefield Water Works, 262 U.S. at 690.

The Minnesota Supreme Court has also provided some legal guidelines for Commission decision-making. In Minnesota Power & Light Company v. Minnesota Public Service Commission, 302 N.W. 2d 5 (1980), the Court said:

> ...The single term "ratemaking" has been used to describe what is really two separate functions:
>
> (1) the establishment of a rate of return, which is a quasi-judicial function; and
>
> (2) the allocation of rates among classes of utility customers, which is a quasi-legislative function.

> ...we now hold that the establishment of a rate of return involves a factual determination which the court will review under the substantial evidence standard.
>
> 302 N.W. 2d at 9.

In conducting its evaluation of the Commission's decision, the Court explained:

> ...A reviewing court cannot intelligently pass judgment on the PSC's determination unless it knows the factual basis underlying the PSC's determination. Judicial deference to the agency's expertise is not a substitute for an analysis which enables the court to understand the PSC's ruling. Henceforth, we deem it necessary that the PSC set forth factual support for its conclusion. The PSC must state the facts it relies on with a reasonable degree of specificity to provide an adequate basis for judicial review. We do not require great detail but too little will not suffice.
>
> 302 N.W. 2d at 12.

In order to provide the factual basis for its decision as required by the Court, the Commission will review the testimony of each of the parties on rate of return on common equity, and the objections raised thereto by other parties. The Commission will also review the recommendations of the ALJ. Finally, the Commission will draw its conclusions from the parties' testimony and determine the proper rate of return.

2. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco witness Dr. Fairchild employed a discounted cash flow (DCF) model and a risk premium analysis to derive the ROE for Minnegasco. Based on these analyses, he recommended a return on equity of 12 percent.

The DCF analysis attempts to discern the rate of return required by investors through review of market data. The DCF formula includes two terms: the dividend yield (annual dividends divided by the price of the stock) and the expected growth rate.

Since Minnegasco is not publicly traded, Dr. Fairchild applied the DCF to a comparable group of companies. To determine dividend yield, he divided Value Line’s estimate of dividends to be paid by each gas utility over the next 12 months by the recent price reported in Value Line. The average dividend yield for the group was 5.9 percent.
The growth rate was estimated by reviewing historical and projected growth rates in dividends, book value, earnings per share, and market price. Dr. Fairchild eliminated growth rates below 4.7 percent from the sample because they produced implausible results. The remaining estimates implied that investors expect growth in the 4.7 to 5.7 percent range. Combining the dividend yield and growth rates produced a cost of equity range for Minnegasco between 10.6 and 11.6 percent.

Dr. Fairchild developed his risk premium estimate by utilizing the findings of several equity risk premium studies that have been reported in academic and trade literature. Because these studies employed various approaches and encompassed a variety of time periods and sample groups, Dr. Fairchild adjusted the findings to represent current capital market conditions and the risks of gas distribution utilities.

The studies in Dr. Fairchild's risk premium analysis produced cost of equity estimates ranging from 10.07 percent to 14.94 percent. He eliminated rates below 10.07 percent for failing the 300-basis-point risk premium threshold and the rates over 14 as implausible, leaving a range of 11.68 to 13.37 percent. This range was narrowed by eliminating the low and high values to produce a risk premium cost of equity for Minnegasco between 11.8 and 12.7 percent.

The Department stated that Dr. Fairchild's risk premium analysis is generally flawed because he assumed a constant risk premium, included non-gas industry studies, and there was an inconstancy between the time periods used for his current risk premium analysis.

Dr. Fairchild's analysis implied a base cost of equity range of 11.25 to 12.25 percent for Minnegasco. This range overlaps the upper end of the DCF analysis and the lower end of the risk premium analysis. To recognize flotation costs which he claimed usually result in adjustments between 15 and 50 basis points, Dr. Fairchild selected a cost of equity above the midpoint and recommended 12 percent.

b. The Department

Department witness Dr. Thompson recommended an ROE of 11 percent based on a DCF analysis of a comparable group of gas distribution companies.

Dr. Thompson estimated the dividend yield component by reviewing dividends for: twenty trading days, from 10/18/95 to 11/14/95; the third quarter in 1995; the year ending the third quarter 1995; and the two year period ending the third quarter in 1995. Using these values, Dr. Thompson estimated that 5.5 percent was a reasonable estimate for the dividend yield.

To determine growth rate, Dr. Thompson looked at 5 and 10 year historical growth rates and projected growth rates for book value per share, dividends per share, and earnings per share. He stated that since five and ten year growth rates are used within the financial community with some published regularity and apparent acceptability among investors, they were reviewed along with forecasted rates to determine a reasonable estimate of the growth rate in dividends per share. Based on his analysis, Dr. Thompson recommended a 5.5 percent growth rate for the comparable group.

Minnegasco criticized Dr. Thompson for: using a current dividend yield rather than expected dividend yield; selecting growth rates from the lower end of investor expectations; and failing to include a flotation cost adjustment.

The Department responded that:

- its 5.5 percent dividend yield incorporates an adjustment for the growth rate and is supported by Value Line's expected dividend yield

- the growth rate range of 4.5 percent to 6.5 percent is based on a reasonable analysis of historical growth rates and forecasted growth rates

- there is no evidence that Minnegasco's current investor (NorAm) incurred any flotation costs when it acquired Minnegasco. Therefore, any flotation allowance at this date would be a windfall for NorAm.

c. The ALJ

The ALJ adopted the DCF-based cost of equity estimate recommended by Dr. Thompson. The ALJ indicated that Dr. Thompson's dividend yield estimate that looked at yields over 20 trading days, one quarter, one year and two years appropriately captures the trends which are relevant for setting rates. Using five and ten year growth rates appropriately strikes a balance reflecting current trends, future expectations, and long-term stability. The ALJ found that a return on equity of 11 percent is consistent with generally accepted risk/rate of return guidelines and will allow Minnegasco to attract capital and maintain its financial integrity.

The ALJ stated that Dr. Fairchild's DCF analysis is flawed because his application of the DCF model relies on limited price information from Value Line, which produces unreliable estimates for regulatory purposes. He made no effort to normalize the Value Line group based on recognized risk measures, despite the acknowledged variability in the growth rates for companies in his group.

The ALJ found that Dr. Fairchild's DCF plus risk premium analysis should be rejected. The ALJ stated that this analysis is based on an inconsistent mix of time periods for determining a current cost of equity based on risk premiums, and is fraught with the difficulty of determining an appropriate return on riskless assets and a required rate of return. Furthermore, the studies relied on by Dr. Fairchild were conducted twenty years ago on electric utilities and thus do not address current risk premiums for gas distribution companies.

The ALJ stated that Minnegasco has not demonstrated that it or NorAm incurred any flotation costs or will do so in the test year and recommended that no flotation cost adjustment be made in this case.

3. Commission Action

The Commission agrees with the ALJ that the DCF method is appropriate for determining cost of equity for Minnegasco. The DCF is preferable to other methods because it: (1) is based on acceptable financial theory; (2) is based on reasonable assumptions concerning investors' expectations; (3) is commonly understood and accepted in regulatory proceedings; and (4) provides the most current rate of return estimates when reasonably and consistently applied.

The cost of common equity cannot be directly observed in the marketplace but can be inferred from market data with the application of reasoned judgment. The DCF method seeks to estimate the return required by investors by using the current dividend yield plus the expected growth in dividends.

As an operating division of NorAm, Minnegasco does not issue its own securities; consequently, there is no market data available on Minnegasco. The Commission finds that using a comparable group of local distribution companies for estimating Minnegasco's cost of equity is appropriate.

The Commission finds that the appropriate return on equity for Minnegasco in the test year is 11.0 percent. In making that determination, the Commission adopts the testimony of Department witness Dr. Thompson.

After careful evaluation of the record in this case, the Commission concludes that Dr. Thompson's analysis provides the most reasonable balance of long- and short-term market data and expert judgment in determining the appropriate ROE for Minnegasco. Dr. Thompson looked at both shorter (20 day and three month) and longer (one and two year) periods in calculating the dividend yield and estimated a yield of 5.5 percent. The Commission finds that this dividend yield appropriately recognizes and captures expected trends in dividend yields during the anticipated regulatory period.

While the current dividend yield is fairly easily observed in the market, the determination of the appropriate growth rate is much more subjective. The Commission must determine the rate at which investors expect Minnegasco dividends to grow in the future. In applying the DCF method, it is reasonable to assume that investors place some weight on past growth trends in determining future expectations. The analysis of historical data must be tempered, however, with the consideration of current and expected economic trends.

Dr. Thompson's growth rate analysis captures most of the data available to investors for determining growth expectations. His use of five and ten year historical data strikes an appropriate balance between recent trends and long-term stability. The use of analysts' forecasts also captures a broad base of expert opinion on future growth rate trends.

Dr. Thompson selected 5.5 percent as a fair and reasonable estimate of expected growth for the DCF analysis. The Commission will adopt a 5.5 percent growth rate.

Combining the 5.5 percent dividend yield with the 5.5 percent expected growth rate, the Commission finds that the cost of equity for Minnegasco is 11.00 percent. This is supported by the Company's DCF analysis which produced a cost of equity range between 10.6 and 11.6 percent. Although Minnegasco claimed that its DCF analysis does not properly reflect the higher long-term growth that investors expect, the Company did not demonstrate that its DCF analysis was inappropriate. The 11 percent is based on substantial evidence in the record and will allow Minnegasco the opportunity to attract capital on reasonable terms and maintain its financial integrity.

The Commission finds that Minnegasco has not sustained its burden of proof in demonstrating that the appropriate cost of equity for Minnegasco is 12 percent. Minnegasco's recommendation is not reasonably linked to the methodologies used by the Company. Dr. Fairchild's DCF analysis resulted in a range of 10.6 to 11.6 percent, while the risk premium model resulted in 11.8 to 12.7 percent. He also based his recommendation on a belief that investors expect long term growth rates to be higher than the growth rates in the DCF model. However, Dr. Fairchild did not calculate a specific growth rate adjustment. The Commission finds that Dr. Fairchild's analysis lacks the clarity and reliability of Dr. Thompson's analysis.

The Commission rejects Minnegasco's reliance on the risk premium model in this case. The Commission has long considered the risk premium model unreliable for use as an estimator of return due to the potential volatility of the results from this method; this record confirms that volatility.

Finally, the Commission rejects the Company's recommendation to add a flotation cost adjustment of 0.22 percent to the Department's required return on equity estimate. The Commission finds that the Company failed to demonstrate that a flotation cost was necessary and did not calculate a specific flotation cost adjustment for its own recommendation. In addition, the record did not contain evidence with respect to actual or projected issuance costs incurred by the Company.

E. Overall Rate of Return

Based upon the Commission's findings and conclusions on return on equity, cost of debt and capital structure herein, the Commission finds the overall rate of return for Minnegasco in the test year to be 9.76 percent, calculated as follows:

Capital Employed	Percent	Cost	Weighted Cost
Long-term Debt	49.94%	8.70%	4.34%
Short-term Debt	1.90	6.40	0.12
Common Equity	48.16%	11.00	5.30
Total	100.00%		9.76%

XIX. RATE DESIGN

A. Factual Background

Ratemaking is essentially a two-step process. First, the Commission determines the revenue requirement, the amount of annual income necessary for the utility to meet reasonable operating and maintenance expenses and earn a fair and reasonable return on the shareholders' investment. This step of the process is quasi-judicial and heavily fact-intensive.

The second step of the process is rate design, when the Commission establishes the utility's rate structure, deciding in what proportions the revenue requirement will be recovered from each customer class. This step of the process is quasi-legislative and heavily policy-intensive.

In determining how to apportion responsibility for the revenue requirement among customer classes, the Commission considers both cost and non-cost factors. Traditional non-cost factors include ability to pay, historical continuity, ease of administration, customer acceptance, ability to pass along costs, ability to bypass the utility, and tax deductibility of utility expenses.

As a starting point in apportioning revenue responsibility, the Commission examines Class Cost of Service Studies, which are designed to determine which customer classes cause which costs. While these studies are by nature imprecise, they provide a rational basis for making judgments about cost causation for cost allocation purposes. Utilities are required to submit such studies under Minn. Rules, part 7825.4300. Traditionally, these studies are fully distributed embedded cost studies, that is, they apportion historic as well as ongoing costs.

B. Class Cost of Service Study

1. The Company's Filing

In this case the Company submitted a traditional, fully distributed Class Cost of Service Study. The study showed, among other things, that rates for residential and small business customers were not recovering costs, while rates for large commercial and industrial customers were over-recovering costs. No other party filed a Class Cost of Service Study.

2. Positions of the Parties

a. The Department

The Department supported the Company's study as reasonable and consistent with past regulatory practice. The Department also recommended that in its next rate case the Company file a Class Cost of Service Study based on marginal cost, the cost of producing each additional unit of service. The Department believed that, as rates grow closer to embedded cost, the Commission will need more information about marginal cost to avoid ratemaking errors.

b. The Suburban Rate Authority

The Suburban Rate Authority (the SRA) claimed the Company's cost study contained two major errors. First, it exaggerated the cost responsibility of residential customers by using a Minimum System approach. That approach does not recognize usage differences between customers in allocating main investment costs. The SRA claimed a demand based approach to main investment would be more accurate and fairer.

Second, the SRA challenged the inclusion of environmental clean-up costs for former manufactured gas plants in the customer component of the cost of the service. The SRA pointed to Company testimony conceding that, when the plants were in operation, their costs would probably have been allocated to the capacity or commodity components of the cost of service.

c. The RUD-OAG

The Residential and Small Business Utilities Division of the Office of the Attorney General (the RUD-OAG) agreed with the Department that the Company should file a Class Cost of Service Study based on marginal cost in its next rate case. While the RUD-OAG did not urge rejection of the Company's cost study, the agency emphasized that fully distributed embedded cost studies have serious weaknesses and shed no light on economic efficiency issues.

The RUD-OAG contended the usefulness of fully distributed embedded cost studies decreases as regulation moves from traditional rate of return regulation to more market-based models.

3. The ALJ

The Administrative Law Judge accepted the Company's Class Cost of Service Study as reasonable and appropriate for making generalized conclusions about class cost of service. He rejected claims that the study can help determine proper price signals or identify subsidies, finding that these issues turned on economic efficiency questions not addressed by fully distributed embedded cost studies.

The Administrative Law Judge recommended requiring the Company to file, in its next rate case, a Class Cost of Service Study based on marginal cost.

4. Commission Action

The Commission agrees with the Administrative Law Judge that the Company's Class Cost of Service Study provides a reasonable basis for reaching general conclusions about the costs of serving different customer classes. It is competently prepared and meets traditional regulatory standards. At the same time, the Commission agrees with the Administrative Law Judge and the RUD-OAG on the inherent weaknesses of fully distributed embedded cost studies.

They offer no help in setting proper price signals. They cannot detect subsidies or cross-subsidization, and worse, they may help obscure or create them. They cannot speak to issues of economic efficiency. They have no relevance to pricing in competitive environments, since only monopolies price to reflect fully distributed embedded costs. These weaknesses are especially troubling as companies expand into competitive markets and as regulation expands its reliance on market forces.

Because the Commission finds the usefulness of the Company's study so limited, and does not intend to rely on it except for the most general purposes, it is unnecessary to make a detailed analysis of the technical issues raised by the SRA. Those issues further illustrate the complexity and subjectivity intrinsic to allocating embedded costs to different customer classes.

Finally, the Commission will require the Company to file in its next rate case a Class Cost of Service Study based on marginal costs, as well as a traditional fully distributed embedded cost study. The Commission agrees with the RUD-OAG that an increasingly competitive environment compels much closer attention to the economic efficiency issues only marginal cost studies can illuminate.

C. Apportioning Revenue Responsibility

1. Positions of the Parties

a. Minnegasco

The Company explained its rate design goals in this case as follows,

> . . . Minnegasco is seeking continued movement toward <u>cost-based rates</u>, to mitigate intra-class and inter-class subsidies paid by customers, send customers proper price signals, and prepare for increasing competition.
>
> Testimony of Tracy Bridge, p. 16.

The Company's Class Cost of Service Study showed large commercial and industrial rates to be above fully distributed embedded cost and residential and small business rates to be below fully distributed embedded cost. The Company therefore proposed to recover all revenue increases authorized in this rate case from residential and small business customers, while reducing or maintaining at current levels large commercial and industrial rates. They also proposed to shift some of the existing revenue requirement to these customers.

b. Minnesota Energy Consumers

The Minnesota Energy Consumers, a group of large industrial energy users, concurred in the Company's rate design proposal.

c. The Department

The Department agreed that residential and small business rates were probably underpriced in relation to fully distributed embedded cost, but considered the Company's proposal too drastic. To avoid rate shock, promote rate stability, prevent customer hardship, and increase customer acceptance, the Department offered an alternative rate proposal. Under the Department's proposal residential customers would still see rate increases of 6.29-6.81% (based on the Company's original request for a $24.3 million increase), but large commercial and industrial rates would not be reduced. They would remain stable or increase slightly.

d. The Suburban Rate Authority

The Suburban Rate Authority, relying on alleged deficiencies in the Class Cost of Service Study described above, urged that any residential rate increase be limited to 150% of the overall percentage revenue increase.

e. The RUD-OAG

The RUD-OAG claimed that the record does not support the Company's claim that shifting revenue responsibility from commercial/industrial customers to residential/small business customers will help send proper price signals, remove subsidies, or prepare the Company for competition. In fact, there are strong indications it could do the opposite. The agency claimed that the wisest course of action, and the only one supported in the record, is to leave class revenue apportionment in its current state.

2. The ALJ

The Administrative Law Judge recommended adopting the Department's position. He not only found the Department's arguments on rate shock persuasive, but found them confirmed in the testimony of residential customers at public hearings. He also found the same concerns expressed in letters from private citizens in the rate case's public comments file.

3. Commission Action

The Commission agrees with the RUD-OAG that the Company has not demonstrated that aligning rates with fully distributed embedded cost and shifting revenue responsibility from large commercial/industrial customers to residential/small business customers will achieve its stated goals of sending proper price signals, removing subsidies, and preparing the Company for competition. In fact, the weight of the evidence points to these measures having the opposite effect.

The Company proposes to move rates to fully distributed embedded cost to position itself for a more competitive environment. In a competitive environment, however, marginal cost, not fully distributed embedded cost, is the touchstone for setting prices and determining the existence and extent of subsidies. Marginal cost has played a secondary role in regulation precisely because that process has stood outside the market.

Regulated monopolies, unlike competitive enterprises, are entitled to a reasonable opportunity to recover all their prudently incurred costs. To ensure that this happens regulators have developed cost-based pricing models which rely heavily on fully distributed embedded cost studies. These models have almost nothing in common with competitive pricing mechanisms. There is no reason to believe these models are readily transferrable to competitive markets or would even make good bridges between regulated and competitive markets.

The RUD-OAG has demonstrated that aligning prices more precisely with fully distributed embedded costs would complicate any future move toward competition. It would make it more difficult to identify subsidies, classically defined as instances in which customers pay more than their stand alone costs. It would make it more difficult to detect cross-subsidization, at a time when the Company's unregulated activities would be expanding. It would make it more difficult to determine and implement proper pricing signals, which are essential to maximizing economic efficiency.

It would shift costs to and raise prices for those customers least likely to have competitive options, and therefore least likely to benefit from the economic efficiencies of competition. It could create an incentive for the Company to carve out a niche for captive customers to which the benefits of competition would never extend.

In short, there is little evidence that aligning price more closely with fully distributed embedded cost would make any transition to competition more successful, and much evidence that it would make it more difficult. There is little evidence that moving price to fully distributed embedded cost would help eliminate subsidies or send proper price signals. Eliminating subsidies and sending proper price signals require an economic efficiency analysis which cannot be performed without marginal cost information missing from this record. The Commission is unwilling to take action that could have anti-competitive effects when it is actively exploring the potential for productive competition in Minnesota energy markets.

Since all record support for changing rate design is targeted at moving price toward fully distributed embedded cost, the Commission believes the soundest course of action is to continue the current allocation of revenue responsibility between customer classes. Current revenue responsibility levels were set in the last rate case on the basis of a complete record and careful analysis. They are just and reasonable by definition. They will remain in effect.

D. Customer or Basic Charges

1. The Company's Filing

Customer or basic charges are charges assessed without regard to usage levels. They are designed to recover fixed costs that do not vary with usage, such as constructing and maintaining infrastructure and conducting billing and collection services. The Company sought changes in basic charges to align them more closely with what their Class Cost of Service Study identified as the fixed costs of serving each customer class.

The Company proposed to raise the basic charge for residential customers from $5.00 to $6.75, to increase basic charges for all but the largest commercial/industrial customers by $1.00-$2.00, to raise large volume dual fuel customer charges by $100, and to stop charging large volume transportation customers $100 more in monthly customer charges than large volume sales customers.

2. Positions of the Parties

a. The Department

The Department recommended limiting the increase in the residential customer charge to $1.00 in the interests of moderation and parity with other gas utilities' customer charges. The Department recommended a similar approach to increasing the "A" class of commercial/industrial customers served by the Northern Natural Gas pipeline and opposed the Company's proposal to stop charging large volume transportation customers $100 more per month than similarly situated sales customers.

b. Suburban Rate Authority

The Suburban Rate Authority opposed any increase in the residential customer charge, arguing that the Company's Class Cost of Service Study overstated customer-related costs. The SRA also argued that the policy reasons the Commission gave for denying a similar request in the last rate case still held, especially those relating to customer confusion and conservation. Finally, the SRA attacked the Company's post-rate case efforts to educate consumers about the customer charge as weak and incomplete.

3. The ALJ

The Administrative Law Judge recommended the Department's gradualist approach toward the residential customer charge, recommended adopting the Company's proposals for commercial/industrial customers in the "A" category, and agreed with the Department that the Company had provided insufficient factual support for its proposal to end the $100 differential in the customer charge for sales and transportation large volume customers.

4. Commission Action

In final Orders in the past several rate cases in which the Commission has examined customer charges, it has expressed grave reservations about permitting greater reliance on these ratemaking devices.[13] Customer charges tend to confuse and alienate customers, neutralize conservation

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[13]These include Minnegasco's last rate case, In the Matter of the Application of Minnegasco, a Division of Arkla, Inc. For Authority to Increase its Rates for Natural Gas Service in Minnesota, Docket No. G-008/GR-93-1090, and others: In the Matter of the Application of Minnesota Power for Authority to Increase its Schedule of Rates for Retail Electric Service in the State of Minnesota, Docket No. E-015/GR-94-1; In the Matter of the Request of Interstate Power Company for Authority to Change its Rates for Gas Service in Minnesota, Docket No. G-001/GR-95-406; In the Matter of the Request of Interstate Power Company for Authority to

incentives, burden low income households, and perpetuate pricing structures ill-suited to competition. For these reasons, the Commission will maintain Minnegasco's customer charges at their current levels.

Customer charges are especially troublesome in the residential context. The cardinal goals in residential ratemaking are making rates understandable, making them easy to administer, and maintaining public confidence in their fairness. Customer charges work at cross purposes with these goals.

The distinction between fixed and variable costs underlying the customer charge is not familiar or readily understandable to most consumers. All providers of goods and services have embedded costs. Non-regulated retailers, however, factor these costs into unit prices, as opposed to assessing surcharges to recover them on a per-customer or per-transaction basis. Consumers are accustomed to having embedded costs factored into unit prices; to the maximum extent possible, residential utility service should be priced in the same way.

The Company would counter that it has conducted a consumer education campaign on the customer charge, inserting reader-friendly explanations of the charge in residential customers' bills in February 1994, June 1995, and October 1995. The Commission continues to believe that such education efforts are better directed toward weightier issues, such as conservation and safety, where customer understanding and cooperation are essential. As the Commission said in the Company's last rate case Order:

> The Commission does not see an education program as the best response to this kind of public resistance to increasing the customer charge. . . .
>
> While the Commission respects the effectiveness of well-designed customer education programs, it is advisable to concentrate educational efforts on issues that more directly affect the public interest, such as safety and conservation. Trying to convince consumers they should think about natural gas prices in regulatory terms would consume resources, creativity, and goodwill which could be put to better use.
> In the Matter of the Application of Minnegasco, a Division of Arkla, Inc. For Authority to Increase its Rates for Natural Gas Service in Minnesota, Docket No. G-008/GR-93-1090, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (October 24, 1994) at 47.

The other concern in the residential context is that unit pricing offers some measure of rate relief to low income, low usage households. The Commission's institutional experience is that every utility's customer base includes some households in this category. The Energy CENTS Coalition has provided compelling evidence of the hardships large utility bills pose for low income households.

Change its Rates for Electric Service in Minnesota, E-001/GR-95-601.

A concern applicable to all ratepayer classes is that large customer charges tend to conflict with the statutory mandate to set rates to encourage conservation. Minn. Stat. § 216B.03 (1994). One of the most powerful tools for heightening conservation-consciousness is maintaining a clear link between consumption and cost. While this link must sometimes be tempered to meet other ratemaking goals, it remains the starting point for setting rates to encourage conservation.

Finally, customer charges, as creatures of regulatory theory, are unlikely to survive any transition from rate of return regulation to competition. While the potential for successful competition in different energy markets is still unclear, the Commission is committed to exploring that potential. Meanwhile, utility regulation continues to move toward market-based strategies to accomplish its objectives. Customer charges are inconsistent with both developments, and the Commission will not permit increased reliance on them during this period of re-evaluation.

For all these reasons, the Commission will require that customer charges for all classes remain at existing levels.

E. Non-Gas Unit Margin for Commercial and Industrial (C&I - "C") Customers

Minnegasco proposed to charge its C&I group "C" customers a lower non-gas unit margin than it charges its C&I group "A" and "B" customers. Currently, the non-gas unit margin is the same for all three segments of the C&I customer class while the customer (basic) charges are different.

The Department did not dispute the lower non-gas unit margin for the C&I - "C" customers.

The Commission does not find that this change (or division of the C&I customer class) would be unreasonable or cause confusion for Minnegasco's customers. The size of the non-gas unit (commodity) margin is a residual amount calculated after the class revenue apportionment is made, and the monthly customer (basic) charge and sales forecast are approved.

Minnegasco may (but is not required to) implement the proposed change in its compliance filing to this case.

F. Division of the Large Volume Dual Fuel (LVDF) Customer Class into Two Parts

Minnegasco proposed to divide the LVDF customer class into two parts. The "A" segment would be for customers who use less than 1,250,000 therms per year and the "B" segment would be for customers who use 1,250,000 therms or more of gas per year. Minnegasco withdrew its proposal for the Viking rate area, in response to the Department's suggestion, because there are no LVDF customers in the Viking rate area.

Minnegasco proposed this division to further the distinction between large and small customers based on their gas usage (load characteristics) and cost of service (specific investment made to serve customers).

The Department did not dispute the Company's proposal for the Northern Natural rate area and noted that Minnegasco's customer-related costs are higher for the larger customers due to higher meter expenses, labor costs associated with the bigger meters and the larger distribution facilities required to serve these customers. The Department believes it would be fair to allow the non-gas unit margin for the "A" segment of the LVDF customer class to be higher than the non-gas unit margin for the "B" segment of the LVDF customer class because customers who use less gas pay for less of their customer-related costs under Minnegasco's current rate design.

The Commission notes that since the Company has not been authorized to modify its revenue apportionment or basic (customer) charges, the "standard" non-gas unit margin for the LVDF "A" and "B" customers will be the same when final rates go into effect.

The Commission does not find that the division of the LVDF customer class would cause confusion for Minnegasco's customers. Therefore, Minnegasco may (but is not required to) implement the proposed change in its compliance filing to this case.

G. Seasonal Rates

1. Positions of the Parties; the ALJ

a. The Department

The Department recommended a "nominal" move in the direction of seasonal (time-of-year) rates because it believes pricing influences consumption. The Department proposed a $.05 per dekatherm increase in the firm sales and transportation non-gas unit margin during the heating season, i.e. from November through March, and a corresponding decrease during the rest of the year to offset the higher winter rate. The Department believes a seasonal, rather than a flat, year-round rate would accomplish the following goals:

- more fairly distribute revenue responsibility within customer classes between high-volume, off-peak users (customers who consume more gas than other customers when the supply is least expensive) and on-peak, low usage customers (customers who consume more gas than other customers when gas is most expensive)

- provide useful information about energy costs to consumers and create an incentive for consumers to shift consumption to the non-heating season part of the year

- may lead to lower total system costs if consumers alter their behavior in response to higher rates during the heating season. When consumers shift their gas consumption to the off-peak time periods, then "Minnegasco might be able to decrease costs associated with peak periods such as fuel, operation, and maintenance costs for peak shavers, premium pipeline capacity, and reservation charges paid to gas suppliers."

- encourage the energy conservation goals in Minn. Stat. § 216B.03 (1994)

- give customers an incentive to flatten their load profile and become more attractive and less expensive for the Company to serve. This would also make these customers more attractive to gas marketers and would help create more alternatives for these customers.

The Department recommended putting seasonal rates in the non-gas unit margin because it would be the simplest way to administer a seasonal rate design and would ensure that all firm customers get the same, predictable seasonal price information. The Department recommended a gradual introduction of the seasonal rate to moderate the bill impacts, safeguard against rate shock, and allow for monitoring the impact of the seasonal rate on energy use.

The Department does not believe the seasonal rate design study submitted by Minnegasco in this case represented a true comparison of the difference between Minnegasco's peak and off-peak rates. The Department also indicated that it does not believe it is necessary to have a completed study on the elasticity of demand for gas to begin experimenting with seasonal rates.

b. Minnegasco

Minnegasco opposed the Department's recommendation because:

- customers already experience seasonal variations in their gas rates through the PGA. Minnegasco argued that the commodity cost of gas can fluctuate as much as $.70 per dekatherm between summer and winter. This amount is much larger than the $.05 per dekatherm variation proposed by the Department.

- ratepayers already consume more gas and receive higher bills in the winter than in the summer. Minnegasco believes this seasonal difference in the total monthly bill sends an adequate price signal to consumers.

- the ratepayers' best interests would not be served by the Department's seasonal rate mechanism because the price variations would not have any real effect on consumption behavior. Minnegasco believes this would also be true for the 37% of its customers who are on levelized budget billing plans.

Minnegasco believed that the arguments the Commission relied on in its decision rejecting seasonal rates for NSP-Gas in its 1992 rate case[14] are also true for Minnegasco. In the 1992 NSP-Gas rate case, the Commission rejected the Department's proposal for seasonal rates because seasonal commodity costs in the PGA already exist and bills are higher in the winter because of higher usage. Minnegasco also argued that the Department has not addressed the related issues the Commission identified in the NSP-Gas case: cost studies; implementation; effect on energy conservation; revenue erosion; and customer migration to the Company's budget plan.

c. The ALJ

The ALJ found the Department's proposal for seasonal rates was unreasonable. The ALJ noted that the Commission rejected a similar proposal by the Department in the NSP-Gas 1992 rate case, for the reasons cited by Minnegasco. The ALJ stated that the parties had not adequately addressed the issues identified by the Commission in the 1992 NSP-Gas rate case.

2. Commission Action

According to Minnegasco, seasonal price variations in its PGA commodity rate already increase rates during the heating season. In addition, consumer bills are higher during the heating season because of increased gas usage.

The Commission is not persuaded that an additional, yet small, seasonal variation in gas rates would fulfil the goals established in Minn. Stat. § 216B.03 (1994) by influencing gas consumption and encouraging energy conservation in a socially useful way.

The Commission also notes that the ALJ found that the issues identified by the Commission in the 1992 NSP-Gas rate case have not been adequately addressed in this case.

The Commission agrees with the Company that seasonal rates are not reasonable at this time and will adopt the ALJ's recommendation to reject the proposal.

H. Exclusion of PGA-Related Information from Customer Bills

1. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco proposed to discontinue showing the purchased gas adjustment (PGA) on customer bills and therefore requested an ongoing variance to Minn. Rules, parts 7820.3500, 7820.3600, and 7825.2700.

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[14] In the Matter of Petition of Northern States Power Company's Gas Utility for Authority to Change Its Schedule of Gas Rates for Retail Customers Within the State of Minnesota, Docket No. G-002/GR-92-1186.

Minnegasco believes removal of PGA-related information from customer bills would alleviate customer confusion and allow customers to more easily verify the calculation of their bills. Minnegasco believes the current level of information provided is burdensome for customers to understand and leads to unnecessary confusion and dissatisfaction.

Minnegasco also claimed that it is burdened by having to explain the PGA to its customers and that customers are only interested in the cost of gas rather than the month-to-month cumulative change in gas costs since the Company's base cost of gas was last established.

Minnegasco also explained that it made this request because customers do not understand the meaning of "base cost of gas" and its relationship to the "purchased gas adjustment." Minnegasco would prefer to use the term "cost of gas" and would like to remove all reference to the PGA from customer bills.

b. The Department

The Department opposed Minnegasco's request because the Department believes:

- customer bills should show the base cost of gas and the current PGA so that consumers can be better informed and more knowledgeable about the gas rates they pay

- customer bills were redesigned in the Company's last rate case to allow the Company to show the PGA in narrative form only at the bottom of each bill. The Department believes that too frequent bill changes cause customer confusion.

- indefinite rule variances are inappropriate as a matter of public policy. The Department suggested that Minnegasco propose a rulemaking if it believes a permanent rule change is necessary.

c. The ALJ

The ALJ agreed with the Department that Minnegasco's proposal to change its billing format and its request for an indefinite variance of PGA-related rules were improper and should be denied. The ALJ was concerned about the propriety of an open-ended variance to any rule and suggested that the proper remedy, if warranted, would be to change the rule.

2. Commission Action

The Commission's customer service and PGA rules require disclosure of all charges and calculations that appear on customer bills in order to keep customers informed about their utility bills and to encourage them to be better consumers. In light of the billing changes approved in the Company's 1993 rate case, further change at this time might bring confusion and is not warranted.

The Commission agrees with the Department's and the ALJ's recommendations and denies Minnegasco's request for an ongoing variance to Minn. Rules, parts 7820.3500, 7820.3600 and 7825.2700.

I. Customer Education

1. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco explained its basic charge in the bill insert notice of rate changes at the end of its last rate case. Minnegasco also explained basic charges in the interim rates notice sent to customers as part of this proceeding. Minnegasco indicated that it was planning to issue another follow-up explanation to the two previously issued customer notices.

b. Suburban Rate Authority (SRA)

The SRA argued that Minnegasco had not adequately educated its residential customers about its basic charge as required by the Commission after Minnegasco's last rate case. SRA does not believe the Company's efforts have fully explained the contents of what Minnegasco claims are approximately $16 per month of customer-related costs in its class-cost-of-service-study.

c. The ALJ

The ALJ found the Company's intention to make additional attempts to educate its customers an adequate response to the SRA's comments about Minnegasco's customer education efforts.

2. Commission Action

Minnegasco serves a large number of customers. A few customers will always have trouble understanding their bill or be unhappy about paying their charges. The Commission is also aware of the difficulty Minnegasco may have explaining the complicated subject of its PGA to these customers. The Commission finds the Company's attempts at consumer education are adequate.

J. Low Income Programs

Minn. Stat. 216B.16, subd. 10 (1995) requires the Commission to order at least one utility to implement a low income pilot project and allows for recovery in rates of the net cost of the project. In February, 1995, Minnegasco began offering a 30% discount to approximately 3,000 of its customers as part of the low income pilot program authorized by the Commission. Docket No. G-008/CI-94-675, <u>In the Matter of a Low Income Residential Pilot Project for Minnegasco</u>.

1. Positions of the Parties; the ALJ

a. Energy CENTS Coalition

ECC argued that "all Minnegasco ratepayers pay for the loss of LIHEAP funding, in the form of increased collection activities and costs associated with those activities, bad debt, customer service administration, arrearage carrying costs, service disconnections and all other related costs." ECC argued that Minnegasco should be required to help make gas bills affordable for low income households by implementing one or more of its recommendations:

Implement a percentage of bill (POB) plan

ECC described its POB proposal as a modified percentage of income payment plan (PIPP) as follows: "[a] PIPP is established for low-income customers based on a percentage of that customers' income that is deemed an affordable utility payment. For example, lower income households would be expected to pay a lower percentage of their income for utility service and higher incomes would pay a greater percentage."

ECC indicated that a percentage of bill plan would be more difficult to administer than a straight 30% discount, would not take household expenses into account, and would lock customers into a fixed, monthly payment.

On the other hand, the percentage of bill plan would maintain existing incentives for low income customers to conserve energy because customers' bills would continue to vary with usage. More importantly, the sliding scale discount would provide greater assistance to lower income customers and less assistance to those with higher incomes.

ECC argued that Minnegasco should establish a POB pilot program to compare with the 30% low income discount program. ECC believes a POB program could be implemented using the criteria already established for the 30% discount pilot program, e.g. 3,000 participants, the evaluation criteria, etc.

Expand the low income 30% discount rate program

Energy CENTS argued that the existing pilot program has not been operating at full capacity and should be expanded. ECC argued that as of September 30, 1995, only 2,544 customers were participating, compared to the authorized number of 3,000, and that Minnegasco was not sufficiently replenishing the program with new participants.

ECC also indicated that the Company's estimate of eligible participants at the time the pilot program was approved was 26,000. ECC believes that increasing the size of the current pilot program to all 26,000 customers would cost residential ratepayers only $.84 per month. Energy CENTS believed these amounts are minimal compared to the social benefits associated with protecting low income customers from service disconnects and from having to make a choice between purchasing food or gas for space heating. Energy CENTS noted that the cost of expanding the program could be mitigated slightly by spreading the cost over all customer classes.

Implement an arrearage forgiveness plan

Arrearage forgiveness programs require customers to make regular monthly payments on the total amount they owe the utility. In exchange, the utility forgives a portion of the past due bill. Arrearage programs help customers become current on their debts but require the utility to write off some of the past due amounts they are owed. In theory, the write offs are justified because some portion of the past due amounts will be uncollectible anyway or be subject to more expensive collection measures.

ECC recommended that Minnegasco begin an arrearage forgiveness program modeled closely after Minnegasco's short- lived Partners Program. ECC "would structure the program exactly the same way [as Minnegasco's Partners Program] except the affordable monthly budget payment would be based on a percentage of bill plan rather than an EAP [energy assistance program] grant." ECC argued that Minnegasco's Partners Program was successful in reducing arrearages, helped customers become current paying their bills, and allowed Minnegasco to collect money that it would not have otherwise received.

Offer a comprehensive customer assistance program

Energy CENTS argued that Minnegasco should be required to offer a "comprehensive customers assistance program [that] combine[s] an affordability component (either discount rate or a percentage of bill plan), a way for customers to catch up on past due bills (arrearage forgiveness), targeted conservation to high consumption households, coordination with EAP and crisis assistance (either through EAP or private fuel funds)."

Energy CENTS argued in favor of utility-sponsored customer assistance programs because these programs "enable utilities to shift ineffective collection costs toward affordability support, to reduce system-wide collection costs and to simultaneously mitigate against problems caused by unaffordable gas bills."

b. The Department

The Department did not respond to ECC's recommendation to expand the availability of the low income discount rate program to additional customers or the recommendation to start an additional pilot program with an alternative design to the straight 30% discount.

The Department recommended that low income program costs should be recovered from all of Minnegasco's firm customers. The Department based this recommendation on its concern about the rate impact this program could have on non-participating, low income Minnegasco customers and its belief that rate design in this matter needs to address all of the Company's rate design goals rather than the single goal of increasing rates based on cost causation. There are many more eligible but non-participating customers than there are participants in the pilot program.

Spreading the cost of the program over all firm customers decreases the burden slightly on non-participating residential customers and does not jeopardize Minnegasco's competitive position with respect to its interruptible and market-rate (other discount) customers.

In further support of its argument that the cost of the pilot program should be spread over all firm customer classes, the Department noted that the majority of Minnegasco's non-participating residential customers are prohibited from receiving a discount and are no more responsible for causing these costs than are Minnegasco's other firm customers.

The Department recommended that all firm customers pay for the low income discount, and that Minnegasco track net savings of the low income discount, with the tracker applying to the entire pilot program (from the beginning of the pilot in early 1995 until the Company changes rates after the pilot ends). The Department also recommended that Minnegasco adjust the September, 1995 balance of the low income discount tracker for estimated positive (rather than zero) savings and actual (rather than estimated) discounts, and adjust the expected discount during the test year for expected attrition.

c. The RUD-OAG

The RUD-OAG agreed with the Department that, in this case, recovery of the net cost of the low income discount rate should come from all firm customers. The RUD-OAG agreed with the Department's argument that the impact on low income customers who do not receive the discount should be minimized by spreading the program's costs over as large a base of customers as possible.

d. Minnegasco

Minnegasco believes it has addressed the issue of making bills affordable for low income customers. Minnegasco argued that it already offers low income customers payment arrangements, discounted rates, referral and administration for energy assistance grants, and conservation improvement programs. Minnegasco also argued that it should not be made primarily responsible for a problem that is a "societal concern."

Minnegasco accepted the Department's recommendations that all firm customers pay for the low income discount and that the Company establish a tracker account.

e. The ALJ

The ALJ stated that he "believes the recommendations given by ECC deserve closer examination by the Commission. This is particularly true in the context of a revenue reapportionment as substantial as that being proposed in this proceeding. It is not in the public interest to wait to gauge the impact of impending or actual cost to LIHEAP funding. The ALJ recommends that ECC's proposals should be examined to determine which is appropriate for implementation on a pilot basis."

The ALJ did not find any evidence in the record of this case to support ECC's allegation that Minnegasco violated the Cold Weather Rule by denying residential customers reinstatement of service during the heating season.

2. Commission Action

In its January 10, 1996, ORDER REQUIRING FILING in Docket No. G-008/CI-94-675, the Commission denied ECC's request for an expansion of Minnegasco's current pilot program:

> The Commission has discretion under Minn. Stat. § 216B.16, subd. 15 (1995) to alter the pilot program in several ways such as, to increase its size, alter the eligibility criteria, etc. However, the purpose of the pilot program is to determine the economic efficiency of offering discounted rates for low-income persons, thereby improving their actual payment record and saving the company arrearage and shut-off related customer service expenses. The Commission finds that altering the parameters of the experiment at this point (one year into the three year program) would unnecessarily complicate (at best) and more likely seriously jeopardize the usefulness of the pilot. In these circumstances, the Commission will not change any aspect of the pilot at this time. Order at p. 6.

The Commission notes that while additional experimentation with pilot programs might be useful, the entire responsibility for conducting such programs should not rest with Minnegasco when there are other gas utilities that could be required to conduct such programs. The Commission finds that further discussions related to expanding current low income programs or starting new programs would benefit from industry wide input and discussion.

In response to ECC's ongoing concern about Minnegasco's low income customers' ability to pay their gas bills the Commission stated, in its January 10, 1996 Order:

> The Commission notes that Energy CENTS continues to raise a very large and important issue: assistance for low-income customers in support of their ability to pay for basic heating utility service. In general, however, the Commission's role with respect to social programs (such as energy assistance) is to respond to legislative direction and leadership. This is particularly appropriate in this case because the legislature has undertaken some action in this regard, as evidenced by the legislation referred to above. Therefore, Energy CENTS' recommendation will not be accepted in this Order.
>
> Finally, the Commission will also reject Energy CENTS' recommendation that the Companies be required to suggest methods to actually expand their programs and to respond to the significant change in LIHEAP funding. The Commission wishes to underline that the problem being addressed here (assistance for low-income customers in support of their ability to pay for basic heating utility service) exceeds the scope of these dockets and, just as important, is not the sole or primary responsibility of the Minnesota gas utility companies. The Commission wishes to underline its view that this is a societal problem that will require a comprehensive approach and will benefit from legislative direction. Order at p. 8.

The Commission finds that its January 10, 1996 decision was reasonable and applies to ECC's request in this proceeding. The Commission finds that it would not be appropriate to require Minnegasco to expand its low income program at this time.

The Commission agrees with the Department's and RUD-OAG's recommendations to require cost recovery from all firm customers and authorizes Minnegasco to establish a tracker account for such purposes as agreed to by Minnegasco and the Department.

The Commission also agrees with the ALJ's finding that there is no evidence in the record of this case that supports ECC's allegation of possible Cold Weather Rule violations. The appropriate forum for disputing the propriety of Minnegasco's implementation of the Cold Weather Rule is through the Commission's consumer mediation process.

K. Obligation to Serve Firm Transport Customers

1. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco does not believe it should "have a continuing obligation to provide Firm Sales Service to customers who elect Firm Transportation Service combined with a third-party supply of natural gas." Minnegasco asked the Commission to formally approve this as a policy decision. Minnegasco argued that it:

> should not have a continuing obligation to be the commodity supplier of last resort for Firm Transportation Service customers who choose a source other than Minnegasco for their natural gas supply. These customers should be in the same position as interruptible sales service customers relative to Minnegasco's supply service obligation. That is, if supply is available after serving the Firm Sales Service customers, other customers will be served. However, Minnegasco should not be placed in a position to procure more firm supply than is necessary to serve Firm Sales Service customers. The Firm Sales Service customers should not have to pay for the back-up or standby gas supply for the Firm Transportation Service customers; the transportation customers must be responsible for obtaining their own back-up firm supplies without passing on costs to others. Minnegasco will continue to be the monopoly service provider for local delivery of natural gas. Therefore, Minnegasco's obligation to serve should apply only to Firm Sales Service (supply and delivery) and Firm Transportation Service (delivery only) and not for other types of back-up supply.

b. The Department

The Department supported the Company's request because Firm Transportation customers have specifically chosen not to be Firm Sales customers. The Department argued that "[c]ustomers who have decided to obtain their own gas supplies should not use Minnegasco's system to supplement their gas supplies unless they are willing to pay for what amounts to a back-up service for the gas they obtain from unregulated suppliers."

The Department made two recommendations related to Minnegasco's obligation to serve:

- Minnegasco should develop a firm back-up (or standby) service similar to NSP's Limited Firm Service and report on the feasibility of offering such a service within 90 days of the Commission's final order in this case, and

- Minnegasco's obligation to serve should be monitored for unforeseen consequences and "Minnegasco [should] report on the effects of this change in service obligation on both transportation and sales customers, along with any effects on operations. Minnegasco should submit this report one year after the effective date of the Commission's Final Order in this case."

2. Commission Action

Minnegasco and the Department are in agreement on Minnegasco's proposal to serve Firm Transport customers who require Firm Sales service on demand or very short notice on a best efforts basis only.

However, the Commission finds that it would be appropriate to defer consideration of issues related to Minnegasco's obligation to serve until the Commission takes up the related matter of Minnegasco's unbundling proposal/aggregation rider in Docket No. G-008/M-95-216, <u>In the Matter of Minnegasco's Petition for Approval of a Miscellaneous Rate Change to Revise its Tariffs in Response to Industry Changes Brought About by FERC Order 636</u>.

L. Three-Part Rate for C&I- "C" Customers

1. Positions of the Parties; the ALJ

a. The Department

The Department recommended expanding the three-part rate design used for Minnegasco's three Large General Service (LGS) customers to include the largest gas users in Minnegasco's Commercial and Industrial (C&I) customer class, i.e. the group "C" class segment. The Department recommended that this rate be developed and proposed by Minnegasco as a mandatory rate for the C&I - "C" customers in Minnegasco's next general rate filing. The Department believes a three-part rate would encourage customers to conserve energy on-peak, better align cost causation with cost recovery, and provide C&I - "C" customers with more accurate price signals.

The Department recommended that Minnegasco develop this proposal to include the effects of a three-part rate on bills for customers with various load factors, and provide information about ways these customers could decrease their gas consumption on-peak.

b. Minnegasco

Minnegasco did not oppose designing a three-part rate according to the methodology suggested by the Department in the Department's direct testimony and then studying the three-part rate's potential impact on C&I - "C" and other customers in the Company's next rate case. However, Minnegasco did object to the Department's recommendation that Minnegasco should be required to propose the three-part rate for C&I- "C" customers as a mandatory rate prior to studying alternative rate designs or evaluating rate impacts.

2. Commission Action

There was no dispute over Minnegasco's inclusion of a three-part rate proposal in its next rate case for C&I - "C" customers and there was no dispute over how the rate would be designed. The Commission will defer its decision about whether the three-part rate shall be mandatory for all C&I - "C" customers until it takes up this issue in the Company's next general rate case.

M. Flexible Tariffs

1. Positions of the Parties; the ALJ

a. Minnegasco

Minnegasco proposed to make flexible tariff service (market or discount rate service) available to all of its Large General Service (LGS) and Commercial and Industrial (C&I) firm sales customers who are subject to effective competition, pursuant to Minn. Stat. § 216B.163 (1994).

Minnegasco also proposed to consolidate its market rate services tariffs into one tariff rider. Minnegasco believes consolidating all of its market rates into one tariff rider would "increase administrative efficiency by eliminating several pages of repetitive tariff language. The general terms of Market Rate tariffs are identical with the only difference being the applicability and the rates."

Minnegasco did not dispute any of the Department's recommendations.

b. The Department

The Department recommended allowing Minnegasco to offer flexible rate service to its LGS and C&I - "C" customers only. The Department does not believe the C&I - "A" and C&I - "B" customers are large enough to meet the minimum daily usage requirements established by the flexible rate statute.

The Department believes it would be reasonable to allow Minnegasco to consolidate the flexible rate tariff into one tariff rider. However, the Department recommended the following clarifications be added to the tariff rider:

- standard rate tariffs should be revised to fully inform all customers about the effect of their energy choices and the tariffs that have slightly different language should be modified to conform with the following language:

  > Customers who use, for reasons of price, an energy supply other than natural gas (except biomass energy) or who can feasibly build pipes to bypass Minnegasco's distribution system shall be limited to service under a market-rate service for a minimum of one year.

- the proposed flexible rate (market rate) rider should retain the language in Minnegasco's current market rate tariffs, except as noted above

- the proposed flexible rate (market rate) rider should include a list of minimum and maximum rates for each class of customers subject to effective competition. (The Department recommended that only the commodity portion of the LGS three-part rate be subject to rate flexing.)

The Department also recommended that the Commission require Minnegasco to document and maintain records, until further notice, on the size of these customers and their abilities either to use fuels other than natural gas or to bypass Minnegasco's transportation system. The Department argued that the documentation will provide useful information about customers in these classes and will be necessary to monitor participation in flexible rate service.

2. Commission Action

The Commission finds the proposed extension of flexible rate service to LGS and C&I - "C" customers is not disputed, would be allowed under Minnesota law, and is reasonable.

The consolidation of the various flexible rate (market rate) tariffs into one tariff rider is administratively efficient and the Department's proposed clarifying language is beneficial. The Commission finds the proposed modifications are appropriate.

N. Customer Service Agreements

Minnegasco proposed to replace all of its customer contracts in Section VII of its Gas Rate Book (tariff book). These contracts are for Dual Fuel Sales, Transportation and Market Rate customers, as well as Agency Program and Process Interruptible customers. In addition, the new forms combine Large and Small Volume Dual Fuel Service customer service agreements into one contract form. Minnegasco believes this will simplify the administration of its contracts and make them more convenient for its customers.

The Department did not dispute the Company's proposal.

The Commission finds the Company's revised customer service agreements are reasonable and may be used.

XX. OVERALL FINANCIAL SUMMARIES

A. Rate Base Summary

In its original filing, the Company proposed a rate base of $356,498,000. Incorporating the above findings, the Commission concludes that the rate base for the test year is $349,849,000 as shown below:

	(000)
Utility Plant in Service	$688,481
Less: Accumulated Depreciation	(323,518)
Net Utility Plant in Service	364,963
Customer Advances	(517)
Gas Stored Underground:	
Current	20,778
Non-current	997
Accumulated Deferred Taxes	(32,142)
Working Capital:	
Materials and Supplies	4,759
Deferred Debits and Credits	(12,411)
Cash Working Capital	(1,125)
Other Working Capital	4,547
Total Average Rate Base	$349,849

B. Operating Income Statement Summary

The Company proposed an operating income of $22,229,000 in the original filing. Incorporating the above findings, the Commission concludes that the operating income for the test year is $26,592,000 as shown below:

	(000)
Operating Revenues	
Gas Sales	$573,060
Other Revenues	3,057
Total Operating Revenues	576,117
Operating Expenses	
Cost of Gas	390,510
Production and Other Supply	1,394
Storage	1,096
Distribution and Utilization	25,916
Depreciation and Amortization	29,828
Customer Accounts & Information	25,769
Sales	2,084
Administrative and General	31,260
Maintenance	10,085
Taxes Other than Income	23,786
Federal and State Income Taxes	7,797
Total Operating Expenses	549,525
Total Operating Income	$26,592

C. Gross Revenue Deficiency

Based on the Commission findings and conclusions, the Minnesota jurisdictional gross revenue deficiency for final rates for the test year is $12,882,000 as shown below:

	(000)
Rate Base	$349,849
Rate of Return	9.76%
Required Operating Income	34,145
Test Year Net Operating Income	26,592
Operating Income Deficiency	7,553
Revenue Conversion Factor	1.7056
Revenue Deficiency	$12,882

In the test year income statement, the Commission found total operating revenues of $576,117,000. Increasing revenues by $12,882,000 results in total authorized Minnesota revenues of $588,999,000 for final rates for the test year.

ORDER

1. Minnegasco is entitled to increase gross annual Minnesota jurisdictional revenues by $12,882,000 in order to produce total gross annual jurisdictional operating revenues of $588,999,000.

2. The Commission accepts and adopts the attached Offer of Partial Settlement except for its treatment of line extensions contained in the Stipulation Section.

3. The Commission modifies the Stipulation Section of the Offer of Partial Settlement on the subject of line extensions to reduce rate base by $3,268,994 and disallow associated depreciation in the amount of $146,000.

4. The Commission adopts the ALJ's finding excluding Minnegasco's Exhibits 24 and 27 from the record.

5. Within 60 days of the date of this Order the Company shall make a compliance filing on service extension issues:

    a. demonstrating that the Company understands and has implemented Commission policy requiring individual application of the New Area Surcharge to each new area to which it expands;

    b. describing how the Company will determine when the New Area Surcharge applies;

    c. describing the operating and accounting procedures in place to ensure compliance with the New Area Surcharge tariff;

    d. revising tariff language to clarify that once the Company waives excess footage charges, it cannot at any point recover those charges from ratepayers.

6. In its next rate case filing the Company shall include two Class Cost of Service Studies, one based on fully distributed embedded cost and one based on marginal cost.

7. The allocation of revenue responsibility between customer classes set in the last rate case shall remain in effect.

8. Within 30 days of the date of this Order the Company shall file with the Commission for its review and approval, and serve on all parties to this proceeding, revised schedules of rates and charges reflecting the revenue requirement and the rate design decisions contained herein, along with the proposed effective date.

The compliance filing filed pursuant to this Ordering Paragraph shall contain:

a. A breakdown of Total Operating Revenues by type;

b. Schedules showing all billing determinants for the retail sales of gas. These schedules shall include but not be limited to:

   I. Total revenue by customer class;

   ii. Total number of customers, the customer charge and total customer charge revenue by customer class; and

   iii. For each customer class, the total number of commodity and demand related billing units, the per unit commodity and demand cost of gas, the non-gas unit margin, and the total commodity and demand related sales revenues.

c. Revised tariff sheets incorporating the rate design decisions contained in this Order;

d. Proposed customer notices explaining the final rates and a full explanation of the customer basic charge.

9. Within 30 days of the date of this Order, the Company shall file with the Commission and serve on the parties, a revised base cost of gas and supporting schedules incorporating the changes made herein. The Company shall also file its automatic adjustment establishing the proper adjustment to be in effect at the time final rates become effective. The Department shall review these filings as it does other automatic adjustment filings.

10. Within 30 days of the date of this Order, the Company shall file with the Commission for its review and approval, and serve upon all parties to this proceeding, a proposal to make refunds, including interest calculated at the average prime rate, to affected customers. The Company shall clearly detail adjustments to the refund for the CIP tracker balance and rate case expenses. The Company shall include calculations supporting the CIP tracker balance as of the date final rates are effective.

11. Within 30 days of the date of this Order, the Company shall submit a compliance filing showing the calculation of the environmental tracker account balance as of the beginning of the test year. Minnegasco shall include detailed descriptions of accounting entries as discussed herein, including treatment of deferred costs, recoveries, carrying charge rate, monthly carrying cost calculations, and any other pertinent information.

12. Within 30 days of the date of this Order, the Company shall submit its calculation of the environmental cost recovery charge (ECRC) to be in effect beginning October 10, 1995.

13. Within 30 days of the date of this Order, the Company shall submit a compliance filing showing the calculation of the CIP CCRC based on final and interim rates approved by the Commission. Minnegasco's calculation of CCRC revenues collected during the interim rate period began October 10, 1995, and will end on the date that Minnegasco implements final rates.

14. Within 30 days of the date of this Order, the Company shall submit a compliance filing showing the calculation of the low income cost recovery rate (LICRC) to be in effect beginning October 10, 1995.

    The Company shall recover the cost of the low income discount rate pilot program from all of its firm customers and shall establish a tracker account for such purposes according to the Department’s recommendations:

    a. Minnegasco shall track net savings and the tracker shall apply to the entire period from when the pilot began until the Company changes rates after the pilot ends; and

    b. Minnegasco shall adjust the September, 1995 tracker balance for estimated positive savings and actual discounts, and adjust the expected discount during the test year for expected attrition from the program.

15. Parties shall have 15 days to comment on the filings required in Ordering paragraphs 5 and 8 through 14.

16. On April 1, 1997, and annually thereafter, Minnegasco shall file with the Commission and the Department its status report of the environmental tracker account. The report shall include a detailed summary of all entries and assumptions in arriving at the then current tracker balance. The report shall also include the Company’s forecast of expected results for the future year.

17. The customer charge basic charges shall remain at their current levels.

18. The Commission rejects the Department’s seasonal rates proposal.

19. The Commission rejects the Company’s request for ongoing variances to Minn. Rules, parts 7820.3500, 7820.3600 and 7825.2700, to exclude PGA-related information from customers bills.

20. Minnegasco’s request to be relieved of its obligation to serve firm transportation customers is deferred pending the resolution of Docket No. G-008/M-95-216, <u>In the Matter of Minnegasco’s Petition for Approval of a Miscellaneous Rate Change to Revise its Tariffs in Response to Industry Changes Brought About by FERC Order 636</u>.

21. In its next rate filing, Minnegasco shall include for consideration a three-part rate design proposal for its C&I - "C" customers modeled on the three-part rate for LGS customers.

22. Minnegasco is authorized to consolidate its flexible rate tariffs into one tariff rider and to extend the applicability of the flexible rate to eligible customers in the LGS and C&I - "C" customer classes. The proposed revisions to the language for the tariff rider discussed in the Order are approved and the Company's tariff book shall be amended accordingly.

23. Minnegasco shall document and maintain records, until further notice, on the size of LGS and C&I - "C" customers who receive flexible rate service and their abilities either to use fuels other than natural gas or to bypass Minnegasco's distribution system.

24. The Company's revised customer service agreements are approved.

25. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

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